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IN THE

Supreme Court of the United States

OCTOBER TERM, 1961

No. 453

R. A. BRYAN and RUBY M. BRYAN; C. B. MCNAIRY and ROWENA A. MCNAIRY; W. H. WEAVER and EDITH H. WEAVER, *Petitioners*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

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v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

Petitioners R. A. Bryan and Ruby M. Bryan, C. B. McNairy and Rowena A. McNairy and W. H. Weaver and Edith H. Weaver respectfully pray for a writ of certiorari to the United States Court of Appeals for the Fourth Circuit to review, in part, the judgment of that court entered July 13, 1960 (Appendix B), affirming in part decisions of the Tax Court of the United States, and remanding as to certain issues (not here in controversy) relating to R. A. and Ruby M. Bryan and C. B. and Rowena A. McNairy for further findings. The review here sought is confined to questions concerning the proper application of the collapsible corporation provisions of Section 117(m) of the Internal Revenue Code of 1939.

OPINIONS BELOW

The findings of fact and opinion of the Tax Court in the consolidated cases of Bryan and McNairy (R. 4, 7, 33)* are officially reported at 32 T.C. 104. The findings of fact and opinion of the Tax Court in the Weaver case (R. 50, 51, 75)* are officially reported at 32 T.C. 411. The three cases were consolidated for hearing in the United States Court of Appeals for the Fourth Circuit in Docket No. 8032. The decisions of the Tax Court were affirmed in part and remanded in part by the Fourth Circuit on July 13, 1960, not yet officially reported. A copy of the opinion appears as Appendix C.

JURISDICTION

These proceedings were brought in the Tax Court of the United States under the provisions of Section 6213 of the Internal Revenue Code of 1954 (26 USCA § 6213).

The jurisdiction of this Court is invoked under the provisions of Section 7482 of the Internal Revenue Code of 1954 (26 USCA § 7482), and 28 USCA § 1254.

QUESTIONS PRESENTED

1. Have the Circuit Court and the Tax Court construed Section 117(m) of the Internal Revenue Code of 1939 in harmony with the clear purpose and intent of Congress?

2. Have the courts below correctly interpreted and applied the definition of a "collapsible corporation" in Section 117(m)(2)?

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* References are to Appendix to Brief for the Petitioners below.

3. Have the courts below correctly interpreted and applied the limitation provisions of Section 117(m)(3)(B)?

4. Do cash distributions, as well as distributions in kind, under Section 115(d) of the Internal Revenue Code of 1939, fall within the ambit of Section 117(m)?

5. Do the Regulations promulgated under Section 117(m) find support in the law?

STATUTES AND REGULATIONS INVOLVED

STATUTES:

The statutory provisions involved are Sections 22(a) and (c), 115(d) and 117(m) of the Internal Revenue Code of 1939, and Section 212(b), Revenue Act of 1950, c. 994, 64 Stat. 906. These provisions are set forth in Appendix A.

REGULATIONS:

The Regulation involved is Sec. 29.117-11 of Treasury Regulations 111, promulgated in T.D. 5999, approved March 26, 1953. The material portions of this section are also set forth in Appendix A.

STATEMENT

The facts as stipulated and as found by the Tax Court[1] insofar as they relate to the collapsible corporation issue, may be summarized as follows:

In 1949 the petitioners, R. A. Bryan and C. B. McNairy, together with three other individuals owned a

[1] The Tax Court findings of fact in the Bryan and McNairy cases (which were consolidated) and in the Weaver case are substantially identical on the issue here involved.

corporation, T. A. Loving & Co., which was engaged in the construction business. At that time W. H. Weaver and his wife owned another construction corporation, W. H. Weaver Construction Co., Inc.

Sometime in 1949 the United States military authorities at Fort Bragg, North Carolina, issued an invitation to bid for the construction, financing, and management by private enterprise of 1,000 family housing units on land forming a part of the Fort Bragg Military Reservation. These units were to be constructed primarily for use by military and Government civilian personnel, and the rental rates to be charged were to be within specified limits. The successful bidder was to manage the housing development project and receive a lease for a term of 75 years, the annual rental to be $3 per acre. This construction was to be financed by insured mortgages under the provisions of Pub. L. 211, 81st Cong., 1st Sess., approved August 8, 1949, which added Title VIII to the National Housing Act, which title is popularly known as the Wherry Act.

The two corporations above mentioned, T. A. Loving & Co., and W. H. Weaver Construction Co., formed a joint venture known as Loving-Weaver for the purpose of bidding on this construction. Each corporation owned a 50 per cent interest in the joint venture. The joint venture was the successful bidder.

For the purpose of carrying out the project the Bryan-McNairy interests and the Weaver interests caused two corporations to be organized under the laws of North Carolina on or about March 15, 1950. These were Bragg Investment Co., Inc., hereinafter referred to as Investment, and Bragg Development Co., Inc., hereinafter referred to as Development. The Federal

Housing Administration required that two corporations be formed, instead of one, to carry out the initial proposal for constructing the 1,000 units because of the size of the proposed F.H.A. insured loans. Each of these corporations kept its books and filed its income tax returns on an accrual method and on the basis of a fiscal year ending the last day of February.

The charter of each of the corporations stated that the object for which it was formed was to provide housing for rent or sale, to improve and operate, and to sell, convey, assign, mortgage, or lease any real estate and any personal property. Each charter provided that so long as any property of the corporation was encumbered by a mortgage or deed of trust insured by the Federal Housing Commission it should not engage in any business other than the construction and operation of a rental housing project or projects.

In the case of each corporation the authorized capital stock consisted of 100,000 shares of class A common stock having a par value of $1 per share, 3,999 shares of class B common stock having a par value of $100 per share, and shares of preferred stock having a par value of $1 per share.

Under the certificate of incorporation the preferred stock carried the right to noncumulative dividends at 5 cents per share before any dividend or distribution upon the common stock, the class B stock was entitled to noncumulative dividends of 6 per cent out of current net earnings before payment of any dividends on the class A stock and had priority, upon dissolution, over the class A stock. The class B common stock could be retired at $100 per share after the payment of all interest and principal due and after making provision for

payment of operating expenses, etc., and after the establishment of a reserve fund for replacements. The original charter provided that no such stock could be retired until after the completion of the improvements on the property, or before the final endorsement for mortgage insurance by the Federal Housing Commissioner. The class A common stock had the exclusive voting privilege, except in the case of specified defaults, in which case the preferred stock had the right to elect directors. Upon liquidation the class A common stock was entitled to the entire assets after the payment of the preferred stock and the class B common stock.

Each certificate of incorporation also provided that the preferred stock might be retired and should be retired upon, but in no event before, the termination of any contract of mortgage insurance covering any indebtedness to which the F.H.A. was a party. It was also provided that the corporation should not, without approval of the holders of the majority of the shares of the preferred stock, assign, transfer, dispose of, or encumber any real or personal property, including rents, except as permitted by the terms of the mortgage, and should not consolidate or merge with any other corporation, go into voluntary liquidation, effect any plan of reorganization, redeem or cancel any of its shares of preferred stock, or amend the certificate of incorporation.

Each corporate charter was amended on or about October 23, 1951, to provide *inter alia* that the class B common stock could be redeemed only with funds representing earned or donated surplus and only after receipt of written approval of the holder of the majority of the shares of preferred stock, after submission of financial statements and satisfactory evidence that no

default existed and that redemption would not jeopardize the interest of the mortgage holder or the insurer. It was further provided that any stock so redeemed should be retired and canceled.

Investment and Development each issued its preferred and class A common capital stock for cash at $1 par value per share, on April 17, 1950, as follows:

Type of stock	Number of shares	Name in which issued
Preferred	100	Federal Housing Administration
A common	10	C. B. McNairy
A common	120	W. H. Weaver
A common	30	Edith H. Weaver
A common	25	C. B. McNairy, III
A common	25	Rowena W. McNairy, Trustee
A common	65	Ruby M. Bryan, Trustee
A common	25	R. A. Bryan

Prior to the incorporation of Investment and Development, the McNairy and Weaver interests had arranged for the services of an architect, Seward H. Mott. The F.H.A. required that contracts with architects be in writing and on April 17, 1950, written contracts were executed between Mott and Development and Investment. Those contracts provided that Mott was to receive $2,000 in cash from each of those corporations and was to receive 2,023.71 shares of class B common stock, par value $100 per share, of Investment, and 2,189.53 shares of class B common stock, par value $100 per share, of Development.

On April 17, 1950, Investment issued stock certificate No. 1 in the name of Seward H. Mott for 2,023.71 shares of its class B common stock. Mott immediately endorsed the certificate, which was canceled or retired, and Investment reissued the shares represented thereby as follows:

	Shares
Certificate No. 2—W. H. Weaver	1,011.855
Certificate No. 3—Ruby M. Bryan	607.113
Certificate No. 4—C. B. McNairy	404.742

On April 17, 1950, Development issued stock certificate No. 1 in the name of Mott, representing 2,189.53 shares of its class B common stock. This certificate was also immediately endorsed by Mott and was canceled or retired and Development reissued the same as follows:

	Shares
Certificate No. 2—W. H. Weaver	1,094.765
Certificate No. 3—Ruby M. Bryan	656.859
Certificate No. 4—C. B. McNairy	437.906

(Shares represented by certificate No. 4 were reissued to Rowena A. McNairy on March 1, 1951, by certificate No. 5.)

The actual consideration which Mott was to receive had been fixed prior to the incorporation of Investment and Development. Prior to April 17, 1950, he had received $20,960. The total amount paid to Mott was $28,010 by checks as follows:

Bragg Investment Company, Inc.	$ 2,000
Bragg Development Company, Inc.	2,000
W. H. Weaver	12,005
Ruby M. Bryan	7,203
C. B. McNairy	4,802
Total	$28,010

Each corporation and the Secretary of the Army entered into an agreement entitled "LEASE FOR PRIVATE HOUSING TO BE INSURED UNDER TITLE VIII, NATIONAL HOUSING ACT." The corporation was granted a lease

of the land for 75 years at a rental of $3 per acre, in consideration for its various undertakings, the land to be used for the purpose of erecting, maintaining, and operating a housing project consisting of 500 units in accordance with plans and specifications theretofore submitted and to be approved by the Federal Housing Commissioner. The agreement contained detailed provisions as to the classes to whom the various units might be rented and as to the rental to be charged. It was provided that title to all improvements constructed upon the leased premises by the lessee should, during the term of the lease, remain in the lessee. Upon expiration of the lease, or earlier termination, all improvements were to become the property of the United States Government without compensation, unless the lessee should elect to remove the improvements and restore the premises. It was further provided that the agreement should be binding upon and inure to the benefit of the Government, its assigns, and the lessee and its successors and assigns. It was also provided that the lessee should neither transfer nor assign the lease without the prior written approval of the district engineer.

In 1949 an application (Project No. 053-80001) on behalf of Investment was filed with F.H.A. to insure a loan in the amount of $4,050,000. Commitment was obtained on April 19, 1950, based upon the F.H.A. estimate of replacement cost of $4,505,932, which included an item of architect fees of $204,371, which was the amount of the par value of the Class B common stock which had been issued to Mott, plus $2,000. Thereafter Investment procured an insured loan in the amount of $4,050,000 and contracted with the joint venture, Loving-Weaver, for the construction of the

military housing project at a price of $3,840,350. Construction on the project was commenced on or about April 18, 1950, and was completed on or about March 26, 1951. Final approval by endorsement of the F.H.A. loan guarantee was made on May 2, 1951. Units in the project were first rented on or about November 15, 1950.

In 1949 an application (Project No. 053-80002) on behalf of Development was filed with the F.H.A. to insure a loan in the amount of $4,373,000. Commitment was obtained on April 19, 1950, upon the F.H.A. estimate of replacement cost of $4,869,325, which included an item of architect fees of $220,953, which was the amount of the par value of the class B common stock which had been issued to Mott, plus $2,000. Thereafter Development procured an insured loan in the amount of $4,373,000 and contracted with the joint venture, Loving-Weaver, for the construction of the housing project at a price of $4,148,191. Construction on the project was commenced on or about April 18, 1951. Final approval by endorsement of the F.H.A. loan guarantee was made on August 10, 1951. Units in the project were first rented on or about August 15, 1950.

The F.H.A. project analyses contemplated occupancy at 93 per cent; estimated annual gross income of $440,541 from Investment's project and $466,911 from Development's project; and estimated annual net income, after operating expenses and taxes, of $284,506[2] on the Investment project and $307,232[2] on the Development project.

The corporate charters, in accordance with F.H.A. requirements, required that cash reserves for replace-

[2] No provision for depreciation is reflected in these figures.

ment be deposited with the mortgagee, in addition to the payment of amortization and insurance. The required yearly reserve deposits were estimated at $24,742 for Investment and $26,442 for Development, and monthly deposits based thereon were made.

On August 20, 1951, joint meetings of the stockholders and directors of Investment and Development were held and pursuant to resolutions adopted, all the class B common stock then outstanding was retired at par, the corporations issuing therefor checks dated August 31, 1951, as follows:

	Investment	Development
W. H. Weaver	$101,185.50	$109,476.50
Ruby M. Bryan	60,711.30	65,685.90
C. B. McNairy	40,474.20	43,790.60
Total	202,371.00	218,953.00

In their joint income tax returns for the year 1951 the petitioners reported long term capital gains from the retirement of said Class B stock as follows (R. 15, 59-60):*

	Capital Gain Reported	
	Investment	Development
Weavers	$95,419.50	$103,237.50
Bryans	58,833.30	60,360.90
McNairys	39,222.20	40,240.60

In computing their capital gains the payments theretofore made by petitioners to the architect, Mott, as cost of the Class B common stock aggregating $24,010, were allocated by them as follows:

* References are to Petitioners' Appendix below

	Investment	Development	Total
W. H. Weaver	$5,766	$ 6,239	$12,005
Rowena A. McNairy or C. B. McNairy	1,252	3,550	4,802
Ruby M. Bryan	1,878	5,325	7,203
Total	$8,896	$15,114	$24,010

The respondent, in his deficiency notices to the petitioners, determined deficiencies for the year 1951 by treating as ordinary income, within the provisions of Section 22(a) and Section 117(m) of the Internal Revenue Code of 1939, the full amounts received by them from the redemption of the Class B common stock of Investment and Development (R. 16, 60).*

At some time in 1951 the military authorities at Fort Bragg negotiated with Investment and Development for the construction of an additional 1,000 units similar to those described above. As in the case of the first two projects, 500 units were to be built by each of these corporations. The provisions of the agreements were essentially the same as with regard to the prior projects.

In 1951 an application (Project No. 053-80008) on behalf of Investment was filed with the F.H.A. to insure a loan in the amount of $4,214,000, based upon an F.H.A. estimate of replacement cost of $4,683,694, which included an item of architect fees of $212,595, which was the amount of the par value of the additional class B common stock issued to Mott, plus $2,000, referred to *infra*. Commitment was obtained on June 29, 1951. Thereafter Investment procured an insured loan in the amount of $4,214,000 and contracted with the

* References are to Petitioners' Appendix below.

joint venture, Loving-Weaver, for construction of the project at a price of $3,976,228. Construction was commenced on or about October 9, 1951, and was completed on or about November 4, 1952. Final approval by endorsement of the F.H.A. loan guarantee was made on November 19, 1952.

In 1951 an application (Project No. 053-80009) on behalf of Development was filed with the F.H.A. to insure a loan in the amount of $4,050,000. Commitment in that amount was obtained on June 29, 1951, based upon an F.H.A. estimate of replacement cost of $4,507,326, which included an item for architect fees of $204,437, which is the par value of the additional class B common stock issued to Mott, plus $2,000, referred to *infra*. Thereafter Development obtained an insured loan in the amount of the commitment and contracted with Loving-Weaver for construction of the project at a price of $3,820,100. Construction commenced on or about October 9, 1951, and was completed on or about January 23, 1953. Final approval by endorsement of the F.H.A. loan guarantee was made on January 28, 1953. Units in the project were first rented on or about April 3, 1952.

Here again, as in the case of the first two projects, the F.H.A. project analyses contemplated occupancy at 93 per cent; estimated annual gross income of $440,541 from each of the projects; and estimated annual net income, after operating expenses and taxes, of $284,506[*] on each of the Investment and Development projects. Deposits with the mortgagee for replacement reserves were made monthly by Investment and Development based upon an estimate of $24,742 per year.

[*] No provision for depreciation is reflected in this figure.

Under date of October 8, 1951, Investment issued 566.69 shares of class B common stock to W. H. Weaver Construction Co. and a like amount to T. A. Loving & Co. On the same date Development issued 572,185 shares of class B common stock to W.H. Weaver Construction Co. and a like amount to T. A. Loving & Co. All these shares were issued by each corporation for cash at par value to provide cash to be used for construction of the second 1,000 units. This stock was retired at par on March 2, 1953.

On October 8, 1951, written contracts were negotiated between the two corporations and the architect, Mott, according to the provisions of which Mott was to receive from each corporation $2,000 in cash. In addition it was provided that he should receive 2,105.95 shares of class B common stock of Investment and 2,024.37 shares of class B common stock of Development.

On October 25, 1951, Investment issued in the name of Mott 2,105.95 shares of class B common stock. Mott immediately endorsed the certificate, which was canceled or retired, and on November 13, 1951, Investment reissued the shares as follows:

	Shares
Certificate No. 9—Edith H. Weaver	1,052.975
Certificate No. 10—Ruby M. Bryan	631.785
Certificate No. 11—Rowena A. McNairy	421.190

On October 25, 1951, Development issued in the name of Mott 2,024.37 shares of class B common stock. He immediately endorsed the certificate which was canceled

or retired, and on November 13, 1951, Development reissued the shares as follows:

	Shares
Certificate No. 10—Edith H. Weaver	1,012.385
Certificate No. 11—Ruby M. Bryan	607.311
Certificate No. 12—Rowena A. McNairy	404.874

Mott was paid $24,595.62 in cash as follows:

Bragg Investment Company, Inc.	$ 2,000.00
Bragg Development Company, Inc	2,000.00
Edith H. Weaver	10,297.82
Ruby M. Bryan	6,178.68
Rowena A. McNairy	4,119.12
Total	24,595.62

Here again, as in the case of the first two projects, Mott had agreed with the two corporations and the petitioners upon the above total as the fee he was to receive. In each instance the agreement was made prior to the filing by each corporation with the F.H.A. of its application for mortgage insurance.

On August 31, 1953, special meetings of the directors and the stockholders of the two corporations, Investment and Development, were held. Pursuant to resolutions adopted at such meetings with reference to retirement of 1,049.74 shares of class B common stock of Investment and 920.70 shares of class B common stock of Development, checks were issued by each corporation dated September 21, 1953, as follows:

Name	Checks issued by Investment	Checks issued by Development
Edith H. Weaver	$ 52,487	$ 46,035
Ruby M. Bryan	31,492	27,621
Rowena A. McNairy	20,995	18,414
Total	104,974	92,070

Prior to redeeming the class B common stock, Investment and Development had requested and obtained permission of the F.H.A. for such redemption.

In their joint income tax returns for the year 1953, the petitioners reported long term capital gains from the retirement of said class B stock as follows (R. 20, 21, 64-65)*:

	Capital Gain Reported	
	Investment	Development
Weavers	$49,869.76	$43,739.49
Bryans	29,916.82	26,106.84
McNairys	19,944.88	17,404.56

In computing their capital gain the individuals allocated $20,595.62 of the payments which had theretofore been paid to Mott as cost of the class B common stock as follows:

Name	Investment	Development	Total
Edith H. Weaver	$ 5,250.61	$ 5,047.21	$10,297.82
Ruby M. Bryan	3,150.36	3,028.32	6,178.68
Rowena A. McNairy	2,100.24	2,018.88	4,119.12
Total	10,501.21	10,094.41	20,595.62

The respondent, in his deficiency notices to the petitioners, determined deficiencies for the year 1953 by treating as ordinary income, within the provisions of section 22(a) and section 117(m) of the Internal Revenue Code of 1939, the full amounts received by them from the redemption of the class B common stock of Investment and Development. (R. 21, 65)*

The par value of the class B common stock of each of the corporations, Investment and Development, which had been issued to Mott in connection with each

* References are to Petitioners' Appendix below.

of the projects was capitalized and charged on the books of each corporation as part of construction cost. However, the corporations excluded from their bases for depreciation of the buildings the difference between the par value of the stock issued to Mott and the amounts paid Mott by the individual stockholders.

The income tax returns of Investment showed rental receipts and net income as follows:

Fiscal year ended	Rents	Net income (or loss)
Feb. 28, 1951	$ 53,464.57	($110,535.12)
Feb. 29, 1952	463,675.51	21,403.06
Feb. 28, 1953	729,641.82	(10,748.13)
Feb. 28, 1954	896,541.39	(40,276.45)

In arriving at the net income (loss) set forth above, non-cash expenses were deducted for Federal income tax purposes as follows:[4]

Year	Depreciation	Amortization of Deferred Loan Costs	Total
1951	$ 71,004.71	$1,430.90	$ 72,435.61
1952	143,672.45	3,534.01	147,206.46
1953	224,824.17	3,534.01	228,358.18
1954	299,542.20	3,534.01	303,076.21

The income tax returns of Development showed rental receipts and net income as follows:

Fiscal year ended	Rents	Net income (or loss)
Feb. 28, 1951	$117,046.80	($58,069.66)
Feb. 29, 1952	460,041.23	11,927.31
Feb. 28, 1953	697,845.96	(51,045.00)
Feb. 28, 1954	929,145.04	(19,854.82)

[4] Pet. App. below, 96-97.

In arriving at the net income (loss) set forth above, non-cash expenses were deducted for Federal income tax purposes as follows:[5]

Year	Depreciation	Amortization of Deferred Loan Costs	Total
1951	$ 62,921.27	$1,521.13	$ 64,442.40
1952	140,929.69	3,713.48	144,643.17
1953	233,908.66	3,550.68	237,459.34
1954	307,011.09	3,550.68	310,561.77

The United States Government, pursuant to the power of eminent domain, acquired all right, title, and interest held by the two corporations, Investment and Development, by virtue of the lease contracts hereinabove described, by the filing with the United States District Court for the Eastern District of North Carolina, on November 1, 1957, of a "DECLARATION OF TAKING." The United States deposited with the court an amount of $780,000 as being just compensation. At the time of the trial in the instant case the matter of just compensation had not been completely settled.

The Tax Court sustained the respondent's determination, holding that Investment and Development were collapsible corporations within the meaning of Section 117(m)(2); and that distributions made to the petitioners out of the proceeds of construction loans, in redemption of class B non-voting stock in 1951 and 1953, are attributable to the property constructed, citing, *inter alia*, *Burge* v. *Commissioner* (CA-4, 1958), 253 F. 2d 765 and *Glickman* v. *Commissioner* (CA-2, 1958), 256 F. 2d 108. It also held that whether the cash distributions in redemption of Class B stock were paid out of mortgage loans or out of rentals received

[5] Pet. App. below, 97-99.

by the corporations was immaterial since in either event the gain derived by the shareholders was attributable entirely to the property constructed, within the meaning of section 117(m)(3)(B). The Tax Court also noted that the respondent had apparently abandoned reliance upon section 22(a) of the 1939 Code; and that he had conceded that the amounts taxable should be reduced by the cost basis of the stock to the petitioners.

The Fourth Circuit, in its opinion, sustained the Tax Court for the reasons stated in its opinion in *Spangler v. Commissioner*, 278 F. 2d 665,[6] holding that "the situation here is quite indistinguishable from Spangler." A copy of that portion of the opinion in *Spangler* which relates to the issues which are common to those in the instant cases appears as Appendix D.

REASONS FOR GRANTING THE WRIT

1. The Decision Below is in Conflict With a Later Decision of the Third Circuit

The opinion was filed and judgment entered in the instant cases on July 13, 1960. On July 26, 1960, the United States Court of Appeals for the Third Circuit, in *Jacobson, et al v. Commissioner*, F. 2d , 60-2 USTC ¶9612, reversed the Tax Court decision (32 T.C. 893) where the issue involved construction of Section 117(m), with particular reference to the definition of "collapsible corporation" in subsection (2)(A). As stated by the Third Circuit in *Jacobson, supra*:

> . . . The disputed question of statutory interpretation in these cases is whether the "view to the sale of stock", which under the statutory definition

[6] Now pending on petition for writ of certiorari in this court, No. 240.

makes a corporation collapsible, must have existed before the construction of property was completed, or whether it is sufficient that this state of mind shall come into existence for the first time after the completion of construction.

On the face of the statute Congress is here indicating a state of mind which must attend and gives significance to certain action. That action, as specified in the statute, is not merely any formation or use of a corporation but rather the formation or use of a corporation to construct or produce property. The "view" with which a corporation is used for a particular purpose must necessarily be a view entertained at the time of such use. Thus, only by a distorting disregard of the phrase "for the construction of property" is it possible to reach the conclusion that the "view to sale" contemplated by the statute can arise for the first time in connection with corporate activity after the work of construction is completed.

The opinion in *Jacobson* continues by specifically noting that it conflicts with previous decisions of the Second Circuit in the *Glickman* case, and the Fourth Circuit in the *Burge* case, in the following language:

To us this seems so clear on the face of the statute that we would content ourselves with the foregoing brief analysis of the statutory text were it not for the fact that other highly respected courts have been persuaded to a contrary interpretation. *Glickman* v. *Commissioner*, 2d Cir., 1958, 256 F. 2d 108; *Burge* v. *Commissioner*, 4th Cir., 1958, 253 F. 2d 765.

In the instant cases the Tax Court specifically relied upon its prior decision, as affirmed by the Fourth Circuit, in the *Burge* case and cited, *inter alia*, *Glickman*. On appeal, the opinion of the Fourth Circuit in the in-

stant cases merely refers to its prior opinion in *Spangler v. Commissioner*, 279 F. 2d 665.[7] A copy of the *Spangler* opinion is set forth in Appendix D. As will be noted, the *Spangler* opinion is based upon the former decision in *Burge*, *supra*, in addition to which it cites *Glickman*, *supra*.

The conflict between circuits pointed out in *Jacobson* justifies review by this Court. *Flora v. U. S.* (1958), 357 U.S. 63, 2 L. ed 2d 1165; *Rogers v. Quan* (1958) 357 U.S. 193, 2 L. ed 2d 1252; *N.L.R.B. v. Duval Jewelry Co.* (1958), 357 U.S. 1, 2 L. ed 2d 1097; *Hagues v. U. S.* (1957), 357 U.S. 81, 1 L. ed 2d 671. That conflict deals only with the requisite "view" which is merely a portion of the definition of a "collapsible corporation". Other portions of the definition are equally important, as will be shown in Reasons 2 and 3, *infra*, to avoid a construction which extends the scope of the definition beyond the clear intent and purpose of Congress.

2. The Proper Scope of Section 117(m) Remains of Substantial Importance in the Administration of the Revenue Laws

This Court has heretofore granted writs of certiorari in tax cases where, in addition to a conflict between circuits, it was deemed advisable to grant certiorari because of the substantial importance of the question as to the proper scope of a particular section of the Internal Revenue Code. This was particularly true in *Colony, Inc. v. Commissioner* (1958) 357 U.S. 28, 2 L. ed 2d 1119, where the construction of Section 275(c) of the 1939 Internal Revenue Code was involved, even

[7] See note 6.

[8] Notwithstanding that in both *Burge* and *Glickman* there was a sale of the voting stock to outside interests, whereas here, as well as in *Spangler*, there was no such sale.

though the question was resolved for the future by Section 6501(e)(1)(A) of the 1954 Code. Here, although the collapsible corporation provisions of the Internal Revenue Code of 1954 expand the provisions of Section 117(m) of the 1939 Code, the definition of "collapsible corporation" will continue to be of importance for the future, both under the 1939 Code and the 1954 Code. See also *Commissioner* v. *Hansen* (1959) 360 U.S. 446, 3 L ed 2d 1360.

Certiorari was granted in *Commissioner* v. *LoBue* (1956) 351 U.S. 243, 100 L ed 1142, where it appeared possible that the Tax Court and the Court of Appeals had given too narrow an interpretation to Section 22(a) of the Internal Revenue Code of 1939. In the cases at bar, the lower courts have undoubtedly expanded the scope of Section 117(m) beyond the clear intent and purpose of Congress.

The Fourth Circuit, in its opinion in the instant cases, refers to its prior decision in *Spangler* v. *Commissioner*; *supra*, for its reasons for affirming the Tax Court, holding that "the situation here is quite indistinguishable from Spangler." In *Spangler*, it holds that the attempted distinguishment of *Burge* v. *Commissioner*, (CA-4, 1958) 253 F. 2d 765 was "too fine-spun," notwithstanding that in *Burge*[2] there was a sale by the taxpayer of all of the class A voting stock, whereas in the instant cases, as in *Spangler*, the petitioners continued to hold all of the voting stock. The stock in controversy here was the class B non-voting stock which was redeemed by the corporations. As will be developed in Reason 3, *infra*, one of the purposes which Congress had in mind in the enactment of

[2] As well as in *Glickman*, *supra*.

Section 117(m) was concerned with the sale of the stock *to outside interests*, not a redemption of stock in cash without any diminution of control such as is involved in both the instant cases and in *Spangler*.

Furthermore, the Committee Reports, which also will be discussed under Reason 3, strongly indicate that a "distribution to its shareholders" as it appears in Section 117(m)(2)(A)(i) is confined to a distribution *in kind* of the *property constructed* and does not extend to a distribution in cash.

Finally, the question of whether the realization by the shareholders of "gain attributable to such property" as used in Section 117(m)(2)(A)(ii), and again in subparagraph (3)(B), was properly construed below to include cash distributions, (whether out of the proceeds of F.H.A. insured loans, or out of rentals received by the corporations or out of depreciation reserve), notwithstanding the provisions of Section 115(d) of the 1939 Code, should also be reviewed.

3. The Decision Below Contravenes the Manifest Purpose and Intent of Congress in Enacting Section 117(m)

It is a well established principle that a statute must be construed in accordance with the intent and purpose for which it was enacted; and that, where necessary, such intent and purpose should be ascertained by reference to the legislative history.[10]

The Internal Revenue Code of 1939 was amended to include Section 117(m) by Section 212(a) of the Revenue Act of 1950, c. 994, 64 Stat. 906. The report of

[10] *Reed* v. *Pennsylvania R. Co.* (1956) 351 US 502, 510, 100 L Ed 1366; *Flora* v. *U.S.* (1958) 357 US 63, 2 L ed 2d 1165, rehearing ..... US ..... 4 L ed 2d 623; *Colony, Inc.* v. *Commissioner* (1958) 357 US 28, 2 L ed 2d 1119.

the House Committee on Way and Means dealing with Section 117(m) (H.Rep. No. 2319, 81st Cong., 2d Sess.), also the report of the Senate Finance Committee (S.Rep. No. 2375, 81st Cong., 2d Sess.) appear in Appendix E.

Under the general discussion of "collapsible corporations" in both the House and the Senate Reports, substantially identical language appears. It is clear from each report that the collapsible corporation provisions which became Section 117(m) were enacted to prevent further attempts to convert ordinary income into long term capital gain. It there appears that the "device" had been used principally in the motion-picture industry, where a corporation was organized to make a picture and immediately upon completion of the picture the corporation was liquidated in kind, the stockholders paying a capital gain tax on the excess of the value of the completed picture over the cost of the stock. The fair market value of the completed picture would then constitute the basis for subsequent amortization or depreciation. The stockholders, accordingly, by paying a capital gains tax of 25 percent on the gain, would recover, through amortization or depreciation, the amount of gain at ordinary income tax rates. Another illustration given is that of a contractor who organizes a corporation to build houses for sale and, upon completion thereof and prior to any sale, liquidates the corporation in kind, thereby reporting a long term capital gain and obtaining a new basis for subsequent transactions equal to the fair market value of the houses at date of liquidation.

Under the detailed discussion of the technical provisions of Section 117(m) certain variations of the "device" are discussed. One is the sale of the capital

stock of the corporation to outside interests at a price which reflects the fair market value of the property constructed or produced. This results in precisely the same conversion of ordinary income into capital gain as in the case of complete liquidation of the corporation in kind, since the purchaser of the stock applies his cost of the stock to the cost of the underlying property, thereby fixing his basis for depreciation or subsequent sale at the fair market value of the property produced or constructed.

Another variation of the "device", as was pointed out in the technical discussion of the Committee Reports, might exist if the distribution, in kind, of the property constructed or produced was made by the corporation to its shareholders under Section 115(d) of the 1939 Code. In such case, the amount of the distribution would be the fair market value of the property constructed or produced, and if it exceeded the stockholder's basis for his capital stock, then the excess would be treated as capital gain.

All of the illustrations appearing in the Committee Reports clearly cover "devices" whereby ordinary income is converted into capital gain, whether it be (1) through the liquidation of the corporation after completion of the property constructed or produced, (2) the sale or exchange of the stock of that corporation to outside interests, or (3) through a distribution, in kind, by the corporation to its shareholders without liquidation or partial liquidation of the corporation.

All "devices" for the avoidance of tax through the conversion of ordinary income into capital gain are effectively nullified by Section 117(m). That is the complete scope of Section 117(m), within the intent and purpose of the Congress, as appears from these Re-

ports. It may not validly be extended to a transaction in which there was no such conversion, as here. There can be no such conversion so long as the property constructed remains in the corporation, provided there is no sale or exchange of the capital stock of the corporation to outside interests.

The decisions below, and the cases relied upon below, go far beyond the declared purpose and intent in construing Section 117(m). The corporations organized by the petitioners to construct and operate military housing units on land owned by the United States did just what they were organized to do. They operated the properties constructed, and collected the rents until November 1, 1957, when the United States instituted condemnation proceedings by the filing by the United States of a Declaration of Taking in the United States District Court in Fayetteville, North Carolina. The cash distributions by the corporations to the petitioners in redemption of the Class B non-voting common stock of the corporations in 1951, and again in 1953, did not reduce the net income of the respective corporations incident to the operation of the said housing units, hence there was no conversion of corporate income into capital gain. There was no sale or exchange of the capital stock of the said corporations by the petitioners to outside interests, hence no conversion by that "device" such as is referred to in the Committee Reports. The courts below, in failing to recognize the distinction between the sale of stock to outside interests on the one hand, as was the case in *Burge* and *Glickman*, *supra*, and the situation in *Spangler*, *supra*, and in the instant cases on the other, where there was no such sale, evidences disregard of the declared purpose as stated in the Committee Reports.

Nor was there any distribution in kind to the petitioners of the property constructed, or any interest therein. Hence, that particular "device" referred to in the Committee Reports is not present here. The lower courts are clearly in error in extending the scope of Section 117(m) beyond the declared purpose of Congress to distributions *in cash* by the corporation to its stockholders. As the Committee Reports specifically indicate, only distributions *in kind*, of the *property constructed* or produced are taken out of the ambit of Section 115(d) and brought within the ambit of Section 117(m). The balance of Section 115(d) survives the enactment of Section 117(m), we respectfully submit, the opinions below to the contrary notwithstanding.

The other "device" referred to in the Committee Reports, involving liquidation in kind following completion of the construction of the property, is manifestly not present in the instant cases.

The effect of the decisions below is to construe Section 117(m) as authorizing the conversion of capital gain into ordinary income,—the reverse of the declared purpose. Had there been no distributions in redemption of the Class B stock under the transaction here in controversy, and had the amounts thereof remained in the corporations until they were liquidated following condemnation proceedings instituted in 1957, they would then have become subject to capital gains tax. At most, therefore, the petitioners accelerated the realization of capital gains in 1951 and 1953, instead of awaiting the liquidation and dissolution of the corporation. The interests of the Treasury Department have not suffered by collecting a portion of the capital gains

tax in 1951 and 1953, rather than at a date later than 1957, following the condemnation.

The purpose and intent of Section 117(m) has been completely served when the tax avoidance devices referred to in the Committee Reports have been arrested. In failing to recognize that Section 117(m) was enacted as a shield against tax avoidance, and, instead, in construing the section as a means for raising new and additional taxes, the courts below have erred.

4. The Decision Below Approves Regulations Which Lack Support in the Law

Although the Revenue Act of 1950, under which Section 117(m) was added to the 1939 Code, was approved September 23, 1950, the Treasury Regulations dealing with collapsible corporations were not promulgated until March 26, 1953, at which time Sec. 117-11 of Treasury Regulations 111, was published as T.D. 5999. The delay of nearly three years in promulgating the Regulation was unfortunate, not only because in the meantime taxpayers were without help in construing the statute, but also because the belated Regulation reflected, to some extent, contemplated amendments of the collapsible corporation provisions of the law.

In fact, the report of the Senate Finance Committee dated June 18, 1954 (S.Rep. No. 1622, 83rd Cong., 2nd Sess.) dealing with H.R. 8300, which enacted into law the Internal Revenue Code of 1954, leaves no doubt that the regulation in question anticipated changes which were actually made by the Internal Revenue Code of 1954. The Senate Report in question, appearing in Appendix E, points out certain specific respects in which it was deemed advisable to incorporate the provisions of the regulation into law. Such references

have been emphasized by italics.[11] The implication is plain that the law as it then stood (Sections 117(m) and 115(d) of the 1939 Code) did not support the Treasury Regulation, including Example (1) thereof. (Appendix E)[12] The Regulation in question was accepted as valid in all respects in *Burge*, *supra*, from which the Fourth Circuit quoted in the *Spangler* opinion, *supra*, in disposing of the complaint that the Regulation, particularly Section 29.117-11(c) and Example (1), lacked support in the law.[13] It is patent from a close examination of Section 341(a)(3) and Section 301(c)(3) of the 1954 Code[14] that, for the first time,

[11] App. 45a-49a.

[12] App. 49a.

[13] App. 31a.

[14] § 341. Collapsible corporations

(a) Treatment of gain to shareholders.—Gain from—

* * * * * * *

(3) a distribution made by a collapsible corporation which, under section 301(c)(3)(A), is treated, to the extent it exceeds the basis of the stock, in the same manner as a gain from the sale or exchange of property,

to the extent that it would be considered (but for the provisions of this section) as gain from the sale or exchange of a capital asset held for more than 6 months shall, except as provided in subsection (d), be considered as gain from the sale or exchange of property which is not a capital asset.

§ 301. Distributions of property

(a) In general.—Except as otherwise provided in this chapter, a distribution of property (as defined in section 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

* * * * * * *

(c) Amount taxable.—In the case of a distribution to which subsection (a) applies

* * * * * * *

the entire scope of Section 115(d) of the 1939 Code has been covered into the collapsible corporation provisions of the law.[15] This is manifestly what the Regulation under Section 117(m) of the 1939 Code attempted to do, without statutory support, and the courts below have judicially approved the attempt. To the extent that the Regulation went beyond the law, it was clearly erroneous as an attempted usurpation of legislative authority.[16]

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(3) Amount in excess of basis.—

(A) In general.—Except as provided in subparagraph (B), that portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock, shall be treated as gain from the sale or exchange of property.

(B) Distributions out of increase in value accrued before March 1, 1913.—That portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock and to the extent that it is out of increase in value accrued before March 1, 1913, shall be exempt from tax.

[15] Effective with respect to sales, exchanges, and distributions on or after June 22, 1954 (§ 392(a)).

[16] *Trust of Bingham* v. *C.I.R.* (1945) 325 US 365, 377, 89 L ed 1679; *Social Security Board* v. *Nierotka* (1945) 327 US 358, 369, 90 L ed 727.

CONCLUSION

To resolve the conflict between the Circuit Courts, and to avoid further conflict involving the proper construction of a "collapsible corporation" within the purpose and intent of Congress, it is important that this Court exercise its power of review. Accordingly, the petition for a writ of certiorari to the Fourth Circuit should be granted.

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APPENDIX A

Statutes and Regulations

Internal Revenue Code of 1939:

SECTION 22. GROSS INCOME.

"(a) GENERAL DEFINITION.—'Gross income' includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * *, of whatever kind and in whatever form paid, or from professions, vocations, trades businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *"

* * * * * * *

"(c) DISTRIBUTIONS BY CORPORATIONS.—Distributions by corporations shall be taxable to the shareholders as provided in Section 115."

* * * * * * *

SECTION 115. DISTRIBUTIONS BY CORPORATIONS.

* * * * * * *

"(d) OTHER DISTRIBUTIONS FROM CAPITAL.—If any distribution made by a corporation to its shareholders is not out of increase in value of property accrued before March 1, 1913, and is not a dividend, then the amount of such distribution shall be applied against and reduce the adjusted basis of the stock provided in Section 113, and if in excess of such basis, such excess shall be taxable in the same manner as a gain from the sale or exchange of property. * * *"

* * * * * * *

SECTION 117. CAPITAL GAINS AND LOSSES.

* * * * * *

"(m) COLLAPSIBLE CORPORATIONS.—[as added by Sec. 212(a) of the Revenue Act of 1950, c. 994, 64 Stat. 906]

"(1) TREATMENT OF GAIN TO SHAREHOLDERS.—Gain from the sale or exchange (whether in liquidation or otherwise) of stock of a collapsible corporation, to the extent that it would be considered (but for the provisions of this subsection) as gain from the sale or exchange of a capital asset held for more than 6 months, shall, except as provided in paragraph (3), be considered as gain from the sale or exchange of property which is not a capital asset.

"(2) DEFINITIONS.—

"(A) For the purposes of this subsection, the term 'collapsible corporation' means a corporation formed or availed of principally for the manufacture, construction, or production of property, or for the holding of stock in a corporation so formed or availed of, with a view to—

"(i) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, prior to the realization by the corporation manufacturing, constructing, or producing the property of a substantial part of the net income to be derived from such property, and

"(ii) the realization by such shareholders of gain attributable to such property.

"(B) For the purposes of subparagraph (A), a corporation shall be deemed to have manufactured, constructed, or produced property, if

"(i) it engaged in the manufacture, construction, or production of such property to any extent,

"(ii) it holds property having a basis determined, in whole or in part, by reference to the cost of such property in the hands of a person who manufactured, constructed, or produced the property, or

"(iii) it holds property having a basis determined, in whole or in part, by reference to the cost of property manufactured, constructed, or produced by the corporation.

"(3) LIMITATIONS ON APPLICATION OF SUBSECTION.—In the case of gain realized by a shareholder upon his stock in a collapsible corporation—

"(A) this subsection shall not apply unless, at any time after the commencement of the manufacture, construction, or production of the property, such shareholder (i) owned (or was considered as owning) more than 10 per centum in value of the outstanding stock of the corporation, or (ii) owned stock which was considered as owned at such time by another shareholder who then owned (or was considered as owning) more than 10 per centum in value of the outstanding stock of the corporation;

"(B) this subsection shall not apply to the gain recognized during a taxable year unless more than 70 per centum of such gain is attributable to the property so manufactured, constructed, or produced; and

"(C) this subsection shall not apply to gain realized after the expiration of three years following the completion of such manufacture, construction, or production.

For purposes of subparagraph (A), the ownership of stock shall be determined in accordance with the rules prescribed by paragraphs (1), (2), (3), (5), and (6) of section 503(a), except that, in addition to the persons prescribed by paragraph (2) of that section, the family of an individual shall

include the spouses of that individual's brothers and sisters (whether by the whole or half blood) and the spouses of that individual's lineal descendants."

* * * * * * *

Revenue Act of 1950, Approved September 23, 1950, Public Law 814 (c. 994, 64 Stat. 906):

SECTION 212. TREATMENT OF GAIN TO SHAREHOLDERS OF COLLAPSIBLE CORPORATIONS.

* * * * * * *

"(b) Effective Date.—The amendment made by this section shall be applicable to taxable years ending after December 31, 1949, but shall apply only with respect to gain realized after such date. The determination of the tax treatment of gains realized prior to January 1, 1950, shall be made as if this section had not been enacted and without inferences drawn from the fact that the amendment made by this section is not expressly made applicable to gains realized prior to such date and without inferences drawn from the limitations contained in section 117(m), added to the Internal Revenue Code by this section."

* * * * * * *

Regulations of Commissioner, Promulgated in T. D. 5999, Approved March 26, 1953.

REG. 111, SEC. 29.117-11. COLLAPSIBLE CORPORATIONS.—(a) IN GENERAL.—With respect to taxable years ending after December 31, 1949, but only with respect to gain realized after such date, and subject to the limitations contained in (e) hereof, the entire gain from (1) the actual sale or exchange of stock of a collapsible corporation, (2) amounts distributed in complete or partial liquidation of a collapsible corporation which are treated, under section 115(c), as payment in exchange for stock, and (3) a distribution made by a collapsible corporation which, under section 115(d), is treated, to the extent it exceeds the basis of the stock, in the same manner as a gain from the sale or ex-

change of property, shall be considered as gain from the sale or exchange of property which is not a capital asset.

(b) DETERMINATION OF COLLAPSIBLE CORPORATION.—With respect to taxable years ending after December 31, 1949, but only with respect to gain realized after such date, a collapsible corporation is defined by section 117(m)(2)(A) to be a corporation formed or availed of principally for the manufacture, construction, or production of property, or for the holding of stock in a corporation so formed or availed of, with a view to (1) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, prior to the realization by the corporation manufacturing, constructing, or producing the property of a substantial part of the net income to be derived from such property, and (2) the realization by such shareholders of gain attributable to such property. With respect to taxable years ending after August 31, 1951, but only with respect to gain realized after such date, the definition of a collapsible corporation under section 117(m)(2)(A) is expanded to include a corporation formed or availed of principally for the purchase of property which (in the hands of the corporation) is properly described in section 117(a)(1)(A), or for the holding of stock in a corporation so formed or availed of, with a view to (1) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, prior to the realization by the corporation purchasing the property of a substantial part of the net income to be derived from such property, and (2) the realization by such shareholders of gain attributable to such property.

See (d) of this section for a description of the facts which will ordinarily be considered sufficient to establish whether or not a corporation is a collapsible corporation under the rules of this section. See (e) of this section for examples of the application of section 117(m).

Under section 117(m)(2)(A), the corporation must be formed or availed of with a view to the action therein described, that is, the sale or exchange of its stock by its shareholders, or a distribution to them prior to the realization by the corporation manufacturing, constructing, producing, or purchasing the property of a substantial part of the net income to be derived from such property, and the realization by the shareholders of gain attributable to such property. This requirement is satisfied in any case in which such action was contemplated by those persons in a position to determine the policies of the corporation, whether by reason of their owning a majority of the voting stock of the corporation or otherwise. The requirement is satisfied whether such action was contemplated unconditionally, conditionally, or as a recognized possibility. If the corporation was so formed or availed of, it is immaterial that a particular shareholder was not a shareholder at the time of the manufacture, construction, production, or purchase of the property, or if a shareholder at such time, did not share in such view, and any gain of such shareholder on his stock in the corporation shall be treated in the same manner as gain of a shareholder who did share in such view. See, however, the limitation contained in (c)(2) hereof. The existence of a bona fide business reason for doing business in the corporate form does not, by itself, negate the fact that the corporation may also have been formed or availed of with a view to the action described in section 117(m)(2)(A).

A corporation is formed or availed of with a view to the action described in section 117(m)(2)(A) if the requisite view existed at any time during the manufacture, production, construction, or purchase referred to in that section. Thus, if the sale, exchange, or distribution is attributable solely to circumstances which arose after the manufacture, construction, production, or purchase (other than circumstances which reasonably could be anticipated at the

time of such manufacture, construction, production, or purchase), the corporation shall, in the absence of compelling facts to the contrary, be considered not to have been so formed or availed of. However, if the sale, exchange, or distribution is attributable to circumstances present at the time of the manufacture, construction, production, or purchase, the corporation shall, in the absence of compelling facts to the contrary, be considered to have been so formed or availed of.

The property referred to in section 117(m)(2)(A) is that property or the aggregate of those properties with respect to which the requisite view existed. In order to ascertain the property or properties as to which the requisite view existed, reference shall be made to each property as to which, at the time of the sale, exchange, or distribution referred to in section 117(m)(2)(A), there has not been a realization by the corporation manufacturing, constructing producing, or purchasing the property of a substantial part of the net income to be derived from such property. However, where any such property is a unit of an integrated project involving several properties similar in kind, the determination whether the requisite view existed shall be made only if a substantial part of the net income to be derived from the project has not been realized at the time of the sale, exchange, or distribution, and in such case the determination shall be made by reference to the aggregate of the properties constituting the single project.

A corporation shall be deemed to have manufactured, constructed, produced, or purchased property if it (1) engaged in the manufacture, construction, or production of property to any extent, or (2) holds property having a basis determined, in whole or in part, by reference to the cost of such property in the hands of a person who manufactured, constructed, produced, or purchased the property; or (3) holds property having a basis determined, in whole or in part, by reference to the cost of property manufactured,

constructed, produced, or purchased by the corporation. Thus, under (1), for example, a corporation need not have originated nor have completed the manufacture, construction, or production of the property. Under (2), for example, if an individual were to transfer property constructed by him to a corporation in exchange for all of the capital stock of such corporation, and such transfer qualifies under section 112(b)(5), then the corporation would be deemed to have constructed the property, since the basis of the property in the hands of the corporation would, under section 113(a)(8), be determined by reference to the basis of the property in the hands of the individual. Under (3), for example, if a corporation were to exchange property constructed by it for property of like kind constructed by another person, and such exchange qualifies under section 112(b)(1), then the corporation would be deemed to have constructed the property received by it in the exchange, since the basis of the property received by it in the exchange would, under section 113(a)(6), be determined by reference to the basis of the property constructed by the corporation.

In determining whether a corporation is a collapsible corporation by reason of the purchase of property, it is immaterial whether the property is purchased from the shareholders of the corporation or from persons other than such shareholders. The property, however, must be property which, in the hands of the corporation, is property of a kind described in section 117(a)(1)(A). Section 117(a)(1)(A) describes the following property: stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business. The determination whether property is of a kind described in section 117(a)(1)(A) shall be made without regard to the fact that the corpora-

tion is formed or availed of with a view to the action described in section 117(m)(2)(A).

Section 117(m) is applicable whether the shareholder is an individual, a trust, an estate, a partnership, a company, or a corporation.

(c) LIMITATIONS ON APPLICATION OF SECTION.—(1) GENERAL.—This section shall apply only to the extent that the recognized gain of a shareholder upon his stock in a collapsible corporation would be considered, but for the provisions of this section, as gain from the sale or exchange of a capital asset held for more than six months. Thus, if a taxpayer sells at a gain stock of a collapsible corporation which he has held for six months or less, this section would not, in any event, apply to such gain. Also, if it is determined, under provisions of law other than section 117(m), that a sale or exchange at a gain of stock of a collapsible corporation which has been held for more than six months results in ordinary income rather than long-term capital gain, then this section (including the limitations contained herein) has no application whatsoever to such gain.

* * * * * * *

(3) SEVENTY-PERCENT RULE.—This section shall apply to the gain recognized during a taxable year upon the stock in a collapsible corporation only if more than 70 percent of such gain is attributable to the property referred to in section 117(m)(2)(A). If more than 70 percent of such gain is so attributable, then all of such gain is subject to this section, and, if 70 percent or less of such gain is so attributable, then none of such gain is subject to this section.

For the purpose of this limitation, the gain attributable to the property referred to in section 117(m)(2)(A) is the excess of the recognized gain of the shareholder during the taxable year upon his stock in the collapsible corpora-

tion over the recognized gain which the shareholder would have if the property had not been manufactured, constructed, produced, or purchased. In the case of gain on a distribution in partial liquidation, or a distribution described in section 115(d), the gain attributable to the property shall not be less than an amount which bears the same ratio to the gain on such distribution as the gain which would be attributable to the property if there had been a complete liquidation at the time of such distribution bears to the total gain which would have resulted from such complete liquidation.

Gain may be attributable to the property referred to in section 117(m)(2)(A) even though such gain is represented by an appreciation in the value of property other than that manufactured, constructed, produced, or purchased. Where, for example, a corporation owns a tract of land and the development of one-half of the tract increases the value of the other half, the gain attributable to the developed half of the tract includes the increase in the value of the other half.

(d) APPLICATION OF SECTION.—(1) Whether or not a corporation is a collapsible corporation shall be determined under the rules of (b) of this section on the basis of all the facts and circumstances in each particular case. The following paragraphs set forth those facts which will ordinarily be considered sufficient to establish that a corporation is or is not a collapsible corporation. The facts set forth in the following paragraphs are not exclusive of other facts which may be controlling in any particular case. For example, if the facts in paragraph (2), but not the facts in paragraph (3), are present, the corporation may nevertheless not be a collapsible corporation if there are other facts which clearly establish that the rules of (b) of this section are not satisfied. Similarly, if the facts in paragraph (3) are present, the corporation may never-

theless be a collapsible corporation if there are other facts which clearly establish that the corporation was formed or availed of in the manner described in (b) of this section, or if the facts in paragraph (3) are not significant by reason of other facts, such as the fact that the corporation is subject to the control of persons other than those who were in control immediately prior to the manufacture, construction, production, or purchase of the property.

See (e) of this section for provisions which make section 117(m) inapplicable to certain shareholders of collapsible corporations.

(2) The following facts will ordinarily be considered sufficient (except as otherwise provided in paragraph (1), above, and paragraph (3), below) to establish that a corporation is a collapsible corporation:

(i) A shareholder of the corporation sells or exchanges his stock, or receives a liquidating distribution, or a distribution described in section 115(d).

(ii) Upon such sale, exchange, or distribution, such shareholder realizes gain attributable to the property described below, and

(iii) At the time of the manufacture, construction, production, or purchase of the property described below, such activity was substantial in relation to the other activities of the corporation which manufactured, constructed, produced, or purchased such property.

The property referred to above is that property or the aggregate of those properties which meet the following two requirements:

(iv) The property is manufactured, constructed, or produced by the corporation or by another corporation stock of which is held by the corporation, or is property purchased by the corporation or by such other corpora-

than which (in the hands of the corporation holding such property) is property described in section 117(a)(1)(A) (relating to stock in trade, inventories, and property held primarily for sale to customers), and

(v) At the time of the sale, exchange, or distribution described in (i) above, the corporation which manufactured, constructed, produced, or purchased such property has not realized a substantial part of the net income to be derived from such property.

In the case of property which is a unit of an integrated project involving several properties similar in kind, the rules of this paragraph shall be applied to the aggregate of the properties constituting the single project rather than separately to such unit. Under the rules of this paragraph, a corporation shall be considered a collapsible corporation by reason of holding stock in other corporations which manufactured, constructed, produced, or purchased the property only if the activity of the corporation in holding stock in such other corporations is substantial in relation to the other activities of the corporation.

(3) The absence of any of the facts set forth in paragraph (2) or the presence of the following facts will ordinarily be considered sufficient (except as otherwise provided in paragraph (1), above) to establish that a corporation is not a collapsible corporation:

(i) In the case of a corporation subject to the rules of paragraph (2) only by reason of the manufacture, construction, production, or purchase (either by the corporation or by another corporation the stock of which is held by the corporation) of property which is property described in section 117(a)(1)(A), the amount (both in quantity and value) of such property is not in excess of the amount which is normal—

(A) For the purpose of the business activities of the corporation which manufactured, constructed,

produced or purchased the property if such corporation has a substantial prior business history involving the use of such property and continues in business, or

(B) For the purpose of an orderly liquidation of the business if the corporation which manufactured, constructed, produced, or purchased such property has a substantial prior business history involving the use of such property and is in the process of liquidation.

(ii) In the case of a corporation subject to the rules of paragraph (2) with respect to the manufacture, construction, or production (either by the corporation or by another corporation the stock of which is held by the corporation) of property, the amount of the unrealized net income from such property is not substantial in relation to the amount of the net income realized (after the completion of a material part of such manufacture, construction, or production, and prior to the sale, exchange, or distribution referred to in paragraph (2)(i)) from such property and from other property manufactured, constructed, or produced by the corporation.

(e) EXAMPLES.—The following examples will illustrate the application of this section:

EXAMPLE (1). On January 2, 1951, A formed the W corporation and contributed $50,000 cash in exchange for all of the stock thereof. The W corporation borrowed $800,000 from a bank, the loan being insured by the Federal Housing Authority, and used $800,000 of such sum in the construction of an apartment house on land which it purchased for $50,000. The apartment house was completed on December 31, 1951. On December 31, 1951, the corporation, having determined that the fair market value of the apartment house, separate and apart from the land,

was $800,000, made a distribution (permitted under the applicable state law) to A of $100,000. At this time, the fair market value of the land was $50,000. As of December 31, 1951, the corporation has not realized any earnings and profits. In 1952, the corporation began the operation of the apartment house and received rentals therefrom. The corporation has since continued to own and operate the building. The corporation reported on the basis of the calendar year and cash receipts and disbursements.

Since A received a distribution and realized a gain attributable to the building constructed by the corporation, since, at the time of such distribution, the corporation has not realized a substantial part of the net income to be derived from such building, and since the construction of the building was a substantial activity of the corporation, the W corporation is considered a collapsible corporation under (d)(2) of this section. The provisions of section 117(m)(3) do not prohibit the application of section 117(m)(1) to A. Therefore, the distribution, if and to the extent that it may be considered long-term capital gain rather than ordinary income without regard to section 117(m), will be considered ordinary income under section 117(m)(1).

In the event of the existence of additional facts and circumstances in the above case, the corporation, notwithstanding the above facts, might not be considered a collapsible corporation. See (b) and (d)(4) of this section.

* * * * * *

EXAMPLE (4). On January 2, 1947, C formed the Y corporation and became the sole shareholder thereof. The Y corporation has been engaged solely in the business of producing motion pictures and licensing their exhibition. On January 2, 1952, C sold all of the stock of the Y corporation at a gain. The Y corporation has produced one

motion picture each year since its organization and prior to January 2, 1952, it has realized a substantial part of the net income to be derived from each of its motion pictures except the last one made in 1951. This last motion picture was completed September 1, 1951. As of January 2, 1952, no license had been made for its exhibition. The fair market value on January 2, 1952, of this last motion picture exceeds the cost of its production by $500,000. A material part of the production of this last picture was completed on January 1, 1951, and between that date and January 2, 1952, the corporation had realized net income of $500,000 from other motion pictures produced by it. The corporation has consistently distributed to its shareholder its net income when received (after adjustment for taxes).

Although the corporation is within (d)(2) of this section with respect to the production of property, the amount of the unrealized net income from such property ($500,000) is not substantial in relation to the amount of the net income realized, after the completion of a material part of the production of such property and prior to sale of the stock, from such property and other property produced by the corporation ($500,000). Accordingly, the Y corporation is within (d)(3)(iii) of this section, and is not considered a collapsible corporation.

EXAMPLE (5). The facts are the same as in example (4) except that C sold all of his stock to D on February 1, 1951. On January 2, 1952, D sold all of the Y corporation stock at a gain, the gain being attributable to the picture completed September 1, 1951, and not released by the corporation for exhibition. In view of the change of control of the corporation, the provisions of (d)(3)(ii) are not significant at the time of the sale by D, and the Y corporation would be considered a collapsible corporation on January 2, 1952. See (b) and (d)(1) of this section. [Reg. 111, Sec. 29.117-11.]

APPENDIX B

Judgment—Filed July 13, 1960

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 8032

R. A. BRYAN and RUBY M. BRYAN, C. B. McNAIRY and ROWENA A. McNAIRY, W. H. WEAVER and EDITH H. WEAVER, *Petitioners*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

On Petition to Review the Decision of the Tax Court of the United States

This cause came on to be heard on the record from the Tax Court of the United States, and was argued by counsel.

On consideration whereof, It is now here ordered and adjudged by this Court that the decisions of the said Tax Court of the United States, in this cause, be, and the same are hereby, affirmed in part as set forth in the opinion of the Court filed herein; and that this cause be, and the same is hereby, remanded to the Tax Court of the United States for further proceedings in accordance with the opinion of this Court.

(s) SIMON E. SOBELOFF
Chief Judge, Fourth Circuit.

(s) MORRIS A. SOPER
United States Circuit Judge.

(s) CLEMENT F. HAYNSWORTH, JR.
United States Circuit Judge.

(Certification omitted)

APPENDIX C

Opinion of United States Court of Appeals for the Fourth Circuit

No. 8032

(Caption Omitted)

On Petitions to Review the Decisions of the Tax Court of the United States

(Argued March 17, 1960 Decided July 13, 1960)

Before SOBELOFF, *Chief Judge*, and SOPER and HAYNSWORTH, *Circuit Judges*:

(Appearances Omitted)

HAYNSWORTH, *Circuit Judge*:

The taxpayers, R. A. Bryan, C. B. McNairy and W. H. Weaver, are North Carolinians engaged in construction businesses. With respect to their operations in 1951, 1952 and 1953, deficiencies of income tax were asserted. They seek review of adverse decisions of the Tax Court, presenting numerous questions.

I

Bryan and McNairy were partners with Florence L. Rogers, Joe W. Stout and Terry A. Lyon in a venture to construct a rental housing project. Bryan, McNairy and Stout were paid salaries, out of borrowed funds. Each partner receiving salary reported on his income tax return

for 1952 only so much of his salary as was in excess of his proportionate part of the total salary disbursements in the partnership's fiscal year, 1952. The theory was that, since there were no partnership earnings, the payment of salaries out of the proceeds of the loan was in part a return to each of a portion of his capital, while each partner suffered an ordinary business loss to the extent his capital was diminished by reason of the payment of salaries to other partners.

The facts with respect to this issue are fully set forth in the findings and opinion of the Tax Court[1] and more briefly summarized in our opinion in Rogers v. Commissioner,[2] decided this day. What we said in Rogers as to this issue is applicable here. For the reasons there stated the case, as to this issue, will be remanded to the Tax Court for further proceedings not inconsistent with our opinion in Rogers.

II

Bryan and McNairy also raise the second issue we considered in Rogers, the deductibility of North Carolina sales taxes separately billed to the partnership by its vendors. Here, the year 1953, as well as 1952, is involved. Additionally, the identical issue is raised with respect to the operations of another partnership, Onslow Building Company, in which Bryan and McNairy were partners.

For the reasons stated in Rogers v. Commissioner, decided this day, we affirm the holding of the Tax Court that these taxes must be capitalized as part of the cost of the capital assets with respect to which they were paid.

III

Two construction companies, T. A. Loving & Co., controlled by the taxpayers, Bryan, McNairy and others, and

[1] 32 T.C. 101

[2] F.2d

W. H. Weaver Construction Company, controlled by the taxpayers, Weaver, formed a joint venture for bidding upon certain Wherry Act[3] housing projects. Through two corporations, organized for the purpose, they constructed four separate projects with FHA insured loans aggregating $16,687,000. In line with the estimates in the loan applications, class B common stock, having an aggregate par value of $834,356, was issued to Seward H. Mott, an architect. In addition to the stock, Mott received $8,000 in cash. Mott had agreed to do the work for a fraction of the estimated fees and promptly sold his stock having a face value of $834,356 for $44,605.62. The corporation then redeemed a portion of the Mott stock from its purchasers, the taxpayers.[4] The stock turned in for redemption at par by the taxpayers had an aggregate par value of $618,368. These receipts on redemption of the class B stock, the taxpayers reported as long term capital gain after deducting their payments to Mott, their claimed cost basis.

During the entire period, the taxpayers[5] owned the controlling class A stock of the housing corporations.

The facts are only sketchily summarized here. They were found in detail by the Tax Court. Its findings are not questioned here, except it is contended that the aggregate amount of the insured loans did not exceed the aggregate amount of the costs of construction and incidental costs, or, at least, not by the amount found by the Tax Court.

Whether or not initial rental receipts may have been an immediate source of some of the funds used to redeem class B stock is immaterial, however, as we recently held

[3] Title VIII, National Housing Act, 12 USCA § 1748, et seq.

[4] Less than all of the class B stock was redeemed because of restrictions imposed by FHA.

[5] The word is used indiscriminately here as between husband and wife. Each of the three couples filed a joint return.

in Spangler v. Commissioner, 4 Cir., — F 2d —. Indeed the situation here is quite indistinguishable from Spangler. For the reasons there stated, we affirm the holding of the Tax Court that these housing corporations were collapsible within the meaning of § 117(m) of the Internal Revenue Code of 1939 and that the taxpayer's receipts on the redemption of class B stock were taxable to them as ordinary income.

IV

The taxpayer, Weaver, employed an interesting variant of the stock redemption plan by which such promoters seek to appropriate to themselves, free of taxes on ordinary income, FHA's over-commitments on multiple housing projects. The question is whether he became taxable upon his retention of the excess funds provided by FHA when he was relieved of any obligation to repay the insured loan.

Weaver, individually, purchased four tracts of land and constructed 217 houses on them. His total cost of land, land improvements and buildings was $1,485,701.96.[6] Before construction began, however, he had obtained FHA mortgage insurance commitments on each of the houses he proposed to build. These commitments, running to four prospective corporations, as mortgagors, and to Weaver Realty Company, which Weaver controlled, as mortgagee, aggregated $1,692,350. He also obtained a commitment from Federal National Mortgage Association to purchase the FHA insured notes and deeds of trust.

With these commitments in hand, he obtained commitments from a bank for construction loans up to a maximum total of $1,692,350. He obtained advances from the

[6] The construction work on three of the tracts was done by W. H. Weaver Construction Company, Inc. On the fourth tract, it was done by Weaver and one Thomas Wilson, who participated in that phase of the venture.

bank, from time to time, totalling $1,643,500, which exceeded his cost, including the cost of the land, by $157,798.04.

While the houses were under construction, Weaver organized four corporations, each with paid-in capital of $500. When the construction work was done, he conveyed one of the four tracts of land to each of the four corporations in exchange for stock having a total par value of $500 and an assumption of the construction loan on the land and houses transferred. The corporations then borrowed $1,692,350 from the bank secured by their 217 notes and deeds of trust and Weaver's personal guarantee. Weaver's personal loans were paid out of the proceeds of these loans. The corporations issued similar notes and deeds of trust, aggregating $1,692,350 to Weaver Realty Company, which sold them to FNMA in accordance with its commitment. FNMA's checks, payable to Weaver Realty Company, were endorsed over to the bank, in discharge of the indebtedness of the four corporations to the bank.

On his tax return for 1953, Weaver appended a note that he had sold, for stock, land and buildings to the four corporations, which assumed outstanding mortgage indebtedness. He disclosed no figures, but asserted that no gain or loss on these transactions was recognizable, because of the provisions of § 112(b)(5) of the Internal Revenue Code of 1939. That is his position here.

Concentrating upon the corporations' interim assumption of his indebtedness to the bank, the taxpayer glosses over the $157,798.04 he obtained in cash, and asserts that, by virtue of the provisions of § 112(k), the assumption of the indebtedness is not "other property" within the meaning of § 112. He takes comfort in the fact that in the 1939 Code there was no provision comparable to § 357 of the 1954 Code. This leads him to conclude it was quite im-

material that the indebtedness assumed was in excess of his basis.

We need not so restrict our view of what actually occurred. The corporations not only assumed the indebtedness; they paid it, with the result that it freed the large amount of cash in the hands of the taxpayer. Though accomplished by indirection, it was, in effect, a payment of cash, in addition to the stock, for the properties transferred, for Weaver's personal indebtedness to the extent it exceeded his actual cost of the properties was an extraneous thing, having no business connection with the property. As a cash payment, the nonrecognition sections would have no application.

If we consider the matter under § 112(k), however, that section requires that we treat an assumption of liability as "other property," if, considering the nature of the liability and the circumstances surrounding the arrangement for its assumption, it appears that the taxpayer's purpose was to avoid federal income taxes, or was not a bona fide business purpose.

There was testimony that the taxpayer's attorney had advised him to assume no long term debts. That was offered as a business purpose for the transfer of the properties to the corporations, but no attempt is made to suggest any business purpose for his borrowing funds in excess of his cost, or his arranging to have the corporations assume that unrelated personal indebtedness. Clearly, his only purpose was to appropriate to himself a major portion of the excess funds which had been committed by FHA and FNMA, and to do it in a form which gave him hope of avoiding federal taxes on the funds with which he enriched himself. The transfer of the properties to corporations, subject to a debt not exceeding his cost, may well have had a business purpose, but it is his purpose in arranging for the assumption by the cor-

porations of the excess indebtedness which is critical under § 112(k).

We think it plain that Weaver received "other property," and that § 112(b)(5) is inapplicable.

Since the Commissioner properly recognized the gain on the transaction, § 117(o) requires that so much of the gain as was attributable to his transfer of depreciable assets to his wholly owned corporations be taxed as ordinary income. Perhaps the taxpayer would be entitled to have his sale of the land treated as a sale of a capital asset, but as the Tax Court found,[7] not unreasonably, the gain substantially exceeded the amount of the cash he received, upon which alone the Commissioner based the deficiency. The Tax Court found that the land and buildings had a value at least as much as the committed loans. If the land and buildings, in light of their prospects for producing income, had such a value, the stock Weaver received in the exchange would have had substantial value as found by the Tax Court. If that were taken into account, a reasonable allocation of his total gain would disclose a gain on the sale of depreciable assets in a greater amount than the $157,703.04 which the Commissioner added to his gross income. If the Commissioner's assessment was not incorrect, though on the wrong theory, the Tax Court properly supports it and we necessarily affirm.[8]

V.

Bryan complains of the disallowance of his deduction in 1951 of $16,000 claimed to be a bad debt. He had endorsed notes for one Bagley, a beer distributor. At the request of the bank, of which he was a director, Bryan paid the notes

[7] 32 T.C. 411.

[8] Helvering v. Gowran, 302 U.S. 238, 245-247, 58 S. Ct. 154, 82 L. Ed. 224; Coastal Oil Storage Co. v. Commissioner, 4 Cir., 242 F.2d 396; Alexander Sprunt & Son v. Commissioner, 4 Cir., 61 F.2d 424.

and, in April and September 1951, took notes from Bagley, aggregating $16,000.

Bryan testified that nothing had been paid on the notes, though payment had been demanded. He said he talked to Bagley and to officials at the bank and came to the conclusion that Bagley was insolvent when the notes were delivered. He produced none of the information that led to the conclusion. Bagley was in active business. The worth of the business Bryan did not know. He said Bagley owed $6,000 to another person and an unknown amount to a third creditor, but such proof hardly establishes the insolvency of a beer distributor.

We think the Tax Court was not required to accept the taxpayer's unsupported conclusion that the notes were worthless in 1951.

VI

The Commissioner included in McNairy's 1951 income certain commissions accrued during that year. He did so on the theory that McNairy was on an accrual basis.

Admitting he used an accrual method for the deduction of state income tax payments, McNairy testified that he reported salaries and commissions in the year of their receipt and took other deductions in the year of payment. He showed unfamiliarity with the returns and their preparation. He did not know of items, other than state taxes, reported on the accrual method and "thought (he) was on a cash basis." McNairy's accountant was a witness, but did not say what basis was used by him in preparing McNairy's return.

On this record, we think there was such uncertainty that a finding that the Commissioner's determination was incorrect was not required.

VII

The Bryans and the McNairys filed declarations of estimated tax shortly before, or shortly after, the close

of each of the years 1951, 1952, and 1953, except the McNairys never filed one for 1952. The Tax Court sustained the imposition of penalties for late filing under § 294(d)(1)(A) of the Internal Revenue Code of 1939.

Bryan and McNairy relied upon an accountant to prepare their returns and declarations, and they seek to excuse their tardiness on the ground that he did not prepare the declarations earlier. They do not claim that he advised them that declarations were not required to be filed earlier, and the Tax Court found that these very prosperous business men with large tax liabilities must have been aware of the much publicized requirement of the filing of declarations by March 15 of the current year. The taxpayers made no effort to furnish the accountant with information for the preparation of a declaration until it was many months past due.

Reliance upon the mistaken advice of a professional man, believed to be expert, may be reasonable cause for delay in filing.[9] The neglect of the accountant, however, does not always establish the care of the taxpayer. He may be guilty of wilful neglect, too. At least here, we think it was a question of fact and that we are bound by the Tax Court's finding.[10]

VIII

The penalty for underestimation was also assessed against Bryan for 1952. His tardy declaration for that year disclosed his estimate as $10,164.80, though on his return filed later, he reported a much larger liability.

[9] McIntyre v. Commissioner, 6 Cir., 272 F.2d 188; In re Fisk's Estate; Fisk v. Commissioner, 6 Cir., 203 F.2d 258; Haywood Lumber & Mining Company v. Commissioner, 2 Cir., 178 F.2d 769; Mayflower Investment Company v. Commissioner, 5 Cir., 239 F.2d 624.

[10] Coates v. Commissioner, 8 Cir., 231 F.2d 459; Clark v. Commissioner, 3 Cir., 253 F.2d 715; Ferrandina v. United States, 6 Cir., 215 F.2d 582; Southgate Finance Co. v. Commissioner, 5 Cir., 194 F.2d 205.

In Commissioner v. Acker,[1] it was decided that both penalties could not be assessed against a taxpayer who filed no declaration. Filing no declaration is not an affirmative estimate of no tax liability. It may be incongruous that one who tardily files an underestimate subjects himself to greater penalties than would have been imposed had he filed no declaration, but we find nothing in this situation to suggest that the Congress meant the two penalties to be mutually exclusive. The amount of the penalty under § 294(d) (2), which cannot exceed six per cent of the excess of the liability over the estimate, is reasonably related to delay in receipt of the money. Since Bryan did file an estimate which fixes the basis of the penalty, we find nothing in Acker which would warrant us in relieving him of it.

Affirmed in part and remanded.

APPENDIX D

Opinion of Fourth Circuit in Spangler v. C.I.R., 278 F. 2d 665

Before SOBELOFF, *Chief Judge*, and SOPER and HAYNSWORTH, *Circuit Judges*.

SOBELOFF, *Chief Judge*:

The "collapsible corporation" provisions of the internal revenue laws are the principal subject-matter of this petition for review. The Commissioner denied capital gains treatment which the taxpayer claimed for certain profits realized by him in the redemption of his stock in two building corporations which he had been instrumental in forming. The Tax Court, in an opinion at 32 T.C. 782, reviewed by the full court, upheld the commissioner's action without dissent. For reasons which will be stated, we affirm its decision.

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[1] 361 U.S. 87.

The 70% Requirement

Section 117(m) does not apply to the gain recognized during a taxable year unless more than 70% of such gain is "attributable to the property" manufactured constructed, or produced. Taxpayer insists that more than 30% of the gain involved was attributable to other factors, such as the construction contract refund from the Construction Company to Double Oaks, rentals from the properties, and off-site improvements. In Burge v. Commissioner, 253 F.2d 765, 769-770, this court, answering a similar contention, stated:

> "Equally specious is the contention that because the distribution was made from the excess of the construction loan it was not attributable to the property being constructed. The answer, of course, is that without the construction of the property there would have been no construction loan and no excess therein to be distributed to shareholders of the corporation."

We think that here also the taxpayer's argument is without merit since any gains arising from the construction contract refund, rentals and off-site improvements are clearly attributable to the property constructed.

The Claimed Absence of Net Income

Another element of the statutory definition of a "collapsible corporation" is that the redemption, sale, or distribution must occur "prior to the realization by the corporation * * * of a substantial part of the net income to be derived from the property. * * *" The taxpayer argues that the amounts he received in redemption are not within this definition since it is "likely that the corporations will never realize a net income." However, such speculation does not make the statute inapplicable. As the court below aptly observed:

> "The net income to be derived from the properties here would consist of rental income over the life of

> "the properties of the lease. It seems clear, therefore, that at the times of redemption the corporations had not realized substantial parts of the net income to be derived from the properties."

Furthermore, the statute does not require that net income from the property should in fact subsequently develop, if the corporation has been availed of with a view to making the distribution prior to the corporation's realization of a substantial part of net income. Payne v. Commissioner, 5 Cir., 1959, 268 F.2d 617.

The Requisite "View"

Still another element of the statutory definition of a "collapsible corporation" is that it be *formed or availed of* principally for the manufacture, construction, or production of property *with a view to* realization by its shareholders of the gain attributable to the property through the sale or exchange of stock by its shareholders prior to the realization of a substantial part of the net income to be derived from the property. The taxpayer contends that under the Treasury Regulations the requisite view must have existed during the construction of the property, and the view could not have existed at that time in the instant case because the redemptions were made several months after completion of construction.

Neither the decisional law nor the Treasury Regulations support the taxpayer's argument. In Burge v. Commissioner, 253 F.2d 765, 769, we said:

> "It is not necessary that the 'view' exist at the time the corporation is formed. It is sufficient that it exist when the corporation is 'availed of'; and the corporation was availed of here to dispose of all interest that the shareholders had in the project by sale or exchange of stock before it had realized any substantial part of the net income to be derived from the property."

To the same effect are Glickman v. Commissioner, 2 Cir., 1958, 256 F.2d 108 and Sidney v. Commissioner, 2 Cir., 1960, 273 F.2d 928.

The record in this case, particularly illustrated by the steps taken in connection with the architects' stock, powerfully suggests that the requisite view existed when the corporations were formed; the proof is convincing that this view existed when the corporations were "availed of." Even under the Treasury Regulations, upon which petitioner places primary reliance, the requirements of section 29.117-11(b) of Regulations 111 are met if the "view" exists at any time during construction *or thereafter*, provided that the distribution in the latter instance is attributable to "circumstances which reasonably could be anticipated at the time of * * * construction. * * *" As to both Double Oaks and Newland Road, it was abundantly clear from the circumstances, before the completion of construction, that there would be excess loan proceeds; and in each case the taxpayer placed himself in a position to obtain this excess by redemption of his stock.

* * * * * *

Burge v. Commissioner

Taxpayer seeks to distinguish our decision in Burge v. Commissioner, 4 Cir., 1958, 253 F. 2d 765, on the ground that the taxpayer there completely divested himself of his interest in the corporation, whereas in this case the taxpayer continues to own stock in the corporations in question by virtue of his ownership of stock in the C. D. Spangler Construction Company. We think this distinction too fine-spun, and it is fully rebutted by the very language of Burge:

> "The word 'collapsible' considered apart from its context would be somewhat misleading; but there can be no question, we think, as to what Congress meant by a 'collapsible corporation' as used in the statute. That term was used to describe a corporation which is

made use of to give the appearance of a long term investment to what is in reality a mere venture or project in manufacture, production or construction of property, with the view of making the gains from the venture or project taxable not as ordinary income, as they should be taxed, but as long term capital gains. Because the basic type of transaction which gave rise to the legislation involved the use of temporary corporations which were dissolved and their proceeds distributed after tax avoidance had been accomplished, the term 'collapsible corporation' was employed to describe the corporations used for this form of tax avoidance; but the statute was drawn in broad general terms to reach the abuse which had arisen, whatever form it might take" 253 F. 2d 765, 767

See also Glickman v. Commissioner, 2 Cir., 1958, 256 F. 2d 108; Abbott v. Commissioner, 3 Cir., 1958, 258 F. 2d 537; August v. Commissioner, 3 Cir., 1959, 267 F. 2d 829; Payne v. Commissioner, 5 Cir., 1959, 268 F. 2d 617; Sidney v. Commissioner, 2 Cir., 1960, 273 F. 2d 928.

Section 115(d)

It is further insisted that the commissioner's regulations under section 117(m) are invalid (1) to the extent that transactions under section 115(d), 26 U.S.C.A. § 115 (d),[4] are erroneously brought within the ambit of section 117(m), and (2) in "treating as a collapsible corporation any corporation which obtained a loan in excess of the adjusted basis of the property and thereafter made any kind of distribution to its stockholders."

The essence of section 117(m) is to limit the area of capital gains treatment, by excluding profits derived by the taxpayer through the use of collapsible corporations. Section 117(m) was expressly designed to treat as ordinary income profits which would otherwise be capital gains under section 115(d) or other sections where (as here, the cor-

[4] (Footnote omitted)

poration making the distribution is resorted to for the purpose of camouflaging a taxpayer's business income to give it the appearance of an investment. The very language of the section discloses that it applies to all gain from the sale or exchange of stock of a collapsible corporation "to the extent that it would be considered (*but for the provisions of this subsection*) as gain from the sale or exchange of a capital asset held for more than 6 months" (emphasis supplied), and it requires such gain to be considered ordinary income.

As for taxpayer's complaint that the regulations, particularly section 29.117-11(c), Example (1),[2] lacked support in the law in deeming a corporation collapsible if it obtained a loan in excess of the adjusted basis of property and thereafter made a distribution to its shareholders, we think it suffices to answer that if the other requirements of section 117(m) are present, the court is free to conclude that such excess, whether channelled to the taxpayer through a refund, a redemption, or in any other form, is gain "attributable to such property." Burge v. Commissioner, 4 Cir., 1958, 253 F.2d 765; Glickman v. Commissioner, 2 Cir., 1958, 256 F.2d 108; Payne v. Commissioner, 5 Cir., 1959, 268 F.2d 617. Furthermore, in Burge, Judge Parker had this to say about the example of the regulations in question:

> "Treasury Regulations 141, sec. 29.117-11(c), Example 1, is directly in point and clearly sustains the action of the Commissioner here. That regulation is important as an administrative construction of the statute and may not be lightly disregarded. Commissioner of Internal Revenue v. South Texas Lumber Co., 333 U.S. 496, 501, 68 S.Ct. 695, 698, 92 L.Ed. 831. As said by the Supreme Court in the case cited:
>
> "'This Court has many times declared that Treasury regulations must be sustained unless unreasonable

[2] (Footnote omitted)

and plainly inconsistent with the revenue statutes and that they constitute contemporaneous constructions by those charged with administration of these statutes which should not be overruled except for weighty reasons. See, e.g., Fawcus Machine Co. v. United States, 282 U.S. 375, 378, 51 S.Ct. 144, 145; 75 L.Ed. 397, 253 F.2d 765,770.

APPENDIX E

Committee Reports on Collapsible Corporations

Revenue Act of 1950, c. 994, 64 Stat. 906
H.R. 2319, 81st Cong., 2d Sess.[1]

(U) COLLAPSIBLE CORPORATIONS[2]

The collapsible corporation is a device which has been used in an attempt to convert ordinary income into long-term capital gain by use of a temporary corporation. The device has been used principally in the motion-picture industry. A legitimate corporation engaged in the business of producing motion pictures would pay ordinarily the corporate income tax on its net income and its shareholders would pay ordinary income tax on their dividends from the corporation. Producers have tried to avoid these results by organizing separate corporations for each motion picture. Upon completion of the film but prior to the realization by the corporation of any income therefrom, the corporation is liquidated and the assets are distributed. In such a case, the corporation pays no tax, claiming that it has realized no income. The producer pays tax upon the difference between his cost and the fair market value of the assets so distributed; but such gain is reported as long-term capital gain with a maximum effective rate of 25 percent. After liquidation, the fair market value of the

[1] C.B. 1950-2, 380.

[2] Id. 422-423.

released production is ordinarily amortized against the income from the film as it is received. If the income from the film does not exceed such fair market value, there is no further tax.

In addition to the motion-picture industry, it is understood that the collapsible-corporation device has also been used in the building-construction trade by contractors who have corporations construct buildings for sale and then liquidate the corporations and sell the buildings as individuals.

Under section 211 of your committee's bill the gain realized from the sale or exchange (including liquidation) of stock in a collapsible corporation will be treated as ordinary income for tax purposes, in the case of a stockholder owning 10 percent or more of the corporation's stock, if the gain realized from the sale or exchange of the stock during the year is more than 70 percent attributable to property produced by the corporation, and the gain is realized within 3 years following the completion of the manufacture, construction, or production of the property.

This provision is applicable only to gains realized after December 31, 1949, but no inference shall be drawn from the amendment with respect to gains realized prior to 1950.

It is estimated that the closing of the collapsible corporation loophole will produce approximately $2 million additional revenue annually.

* * * * * * * *

Section 211. Treatment of Gains to Shareholders of Collapsible Corporations

This section of the bill adds a new subsection (n), relating to collapsible corporations, to section 117 of the Code. The collapsible corporation is a device whereby one or more individuals attempt to convert the profits from their par-

ficipation in a project from income taxable at ordinary rates to long-term capital gains taxable only at a rate of 25 percent.

The term "collapsible corporation" is specifically defined by paragraph (2) of the subsection to mean a corporation formed or availed of principally for the manufacture, construction, or production of property, or for the holding of stock in a corporation so formed or availed of, with a view to (i) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution by the corporation to its shareholders, prior to the realization by the corporation manufacturing, constructing, or producing the property of a substantial part of the net income to be derived from such property and (ii) the realization by such shareholders of gain attributable to such property. The paragraph further states when a corporation shall be deemed to have manufactured, constructed, or produced property.

It will be noted that the term "collapsible corporation" is so defined as to include corporations lending themselves to the attempted tax-saving practice outlined above, whether they are the corporations commencing and completing the project or corporations made use of as holding companies having no other business than to separate the shareholders from the corporation undertaking the project. The corporation, furthermore, has been so defined as to describe corporations different in kind from those which ordinarily liquidate following normal business operations. This objective has been specifically strengthened by the statement made in subparagraph (i) above, to the effect that the sale or exchange or the distribution be made prior to the realization by the corporation of a substantial part of the net income to be derived from the property. On the other hand, in many cases an ordinary corporation may distribute property in kind in the course of its liquidation, or the stock in such a corporation may be sold prior to

the realization by the corporation of the net income to be derived from some of its property, but such a corporation could not be considered to have been formed or availed of principally for the manufacture, construction, or production of that property alone.

While the primary use made of collapsible corporations in the past has usually involved their liquidation in the manner indicated above, it is apparent that the shareholders forming or availing themselves of such a corporation could raise the same tax questions as would be raised by a liquidation *by selling their stock to outside interests at the time and under the circumstances when the corporation might otherwise be liquidated.* In like manner, *the corporation might distribute the property in question without liquidating* and, under section 115(d), the value of the property distributed, to the extent that it was not a dividend, would first be applied against the adjusted basis of the stock to the shareholders and the excess, if any, would be taxable in the same manner as a gain from the sale or exchange of property. Paragraph (1) of the subsection, in prescribing the treatment to be given the gain from the sale or exchange of stock of a collapsible corporation, is deemed to refer to this excess value in the case of a distribution made by the corporation other than in liquidation. *Such a distribution is specifically referred to in connection with the definition of the term "collapsible corporation" in paragraph (2)* of the subsection and both paragraph (1) and paragraph (2) of the subsection refer to the sale or exchange of the stock other than in liquidation. (Emphasis supplied.)

Subparagraph (B) of paragraph (2) of the subsection states that a corporation shall be deemed to have manufactured, constructed or produced property if it engaged in the manufacture, construction or production of such property to any extent or if it holds property having a substituted basis under section 113 of the Code determined by reference to the cost of property manufactured, con-

structed or produced by the corporation or by another. Under this statement the corporation need not have originated the manufacture, construction or production; neither need the manufacture, construction or production be completed by it. It will nonetheless be deemed to have manufactured, constructed or produced property in that its shareholders may realize gain with respect to the additional value added to the property by the manufacture, construction or production to the extent that it was carried out. Likewise, for example, a corporation which manufactured a movie and exchanged its movie with another corporation for a movie manufactured by that corporation in an exchange which would not be taxable for tax purposes would be considered as having manufactured, constructed or produced the movie thus received on the exchange. This latter type of provision is designed to cover an obvious device which might be utilized by a collapsible corporation in an attempt to circumvent the provision which this committe has added to the bill.

Paragraph (3) of the subsection sets forth three limitations on the application of the subsection. First, the subsection shall not apply unless the shareholder selling or exchanging his stock has at some time subsequent to the commencement of the manufacture, construction, or production of the property by the corporation owned more than 10 percent in value of the outstanding stock of the corporation. In determining the ownership of stock of the corporation by that shareholder, the stock ownership rules set forth in section 503(a) of the Code to the extent that they are pertinent are made applicable with the additional provision that the family of an individual shall include, in addition to the persons mentioned in that section, the spouses of that individual's brothers and sisters (whether by the whole or half blood) and the spouses of that individual's lineal descendants. Second, the subsection shall not apply to the gain recognized by a shareholder *from the sale or exchange of his stock* unless more

than 70 percent of such gain *is attributable to the property* so manufactured, *constructed*, or produced. Third, the subsection shall not apply to gain realized after the expiration of 3 years following the completion of such manufacture, construction, or production. (Emphasis supplied.)

It is the purpose of the first limitation to insure that the provision will only be applicable to a shareholder who by virtue of his stock ownership can be presumed to be an interested party to the project whether at the time of its organization or at some intermediate date. The stock ownership rules are made necessary in order to prevent any one shareholder's disguising his interest by the placement of the stock of the corporation among the different members of his family. *Both the second and third limitations relate to the gain realized from the sale or exchange of the stock*, the *second limitation being designed to insure that the application of the subsection will be limited to those corporations* where the *relationship between the gain realized and the property* manufactured, *constructed*, or produced *is substantial*. The third limitation imposes an arbitrary time limit beyond which gain realized will not be subject to the subsection on the theory that a corporation will not be a collapsible corporation as defined in general terms in paragraph (2) if the shareholders do not realize their gain until after 3 years following the completion of the manufacture, construction, or production. (Emphasis supplied.)

Paragraph (1) of the subsection refers to gain from the sale or exchange of a capital asset held for more than 3 months. Under section 117 of the Code, prior to its amendment by this bill, gain from the sale or exchange of a capital asset held for more than 6 months is defined as long-term capital gain. Under section 209(c) of this bill, this period would be changed to 3 months and paragraph (1) has been amended to accord with this change. It is specifically provided in subsection (b) of this section, how-

ever, that in the case of gain realized on or before the date of the enactment of this Act the words "capital asset held for more than 3 months" shall be read as "capital asset held for more than 6 months."

The success of attempts under existing law to make use of a collapsible corporation and to take advantage of the liquidation of that corporation within the meaning of section 115(c) has never been tested in the courts, and it is not clear that individuals making use of the device will succeed in their objectives. *Your committee believes, however, that the proposed amendment dealing specifically with the subject of collapsible corporations is desirable in order to insure that the use of the device in the future will result in no tax advantage.* Thus, under paragraph (1) of the subsection as added to the Code, the gain from the sale or exchange of stock of a collapsible corporation will be treated as gain from the sale or exchange of property which is not a capital asset. This treatment is to be effective, however, only to the extent that the use of the device is interpreted as giving rise to gain which gain is considered (but for the provisions of the subsection) as long-term capital gain. (Emphasis supplied.)

The amendment made by the section is applicable to taxable years ending after December 31, 1949, but only with respect to gain realized after that date. It is specifically provided in the section that the determination of the tax treatment of gains realized prior to January 1, 1950, shall be made as if this section had not been enacted and without inferences drawn from the fact that the amendment made by the section is not made applicable to such gains and without inferences drawn from the limitations contained in the subsection as added to the Code.

Senate Report No. 2375, 81st Cong. 2d Sess.

In the general statements under the caption "(6) Collapsible Corporations," the substantially identical statement which appears in the House Report (H.R. 2319), *supra*, is included in this Report, the only difference being that the House Report refers to Section 211 and this Report to Section 213 of H.R. 8920, which became the Revenue Act of 1950. Dealing specifically with Section 213 the Senate Report states:[1]

> This section corresponds to section 211[2] of the bill as passed by the House. Your committee, however, has made technical amendments and changed the designation of the subsection to be added to the Internal Revenue Code from (n) to (m).
>
> Your committee has also restricted the limitations on the application of the new subsection so as to make subject to the provisions thereof gain realized by a shareholder upon his stock in a collapsible corporation if such shareholder owned stock at any time after the commencement of the manufacture, construction, or production of the property which was considered as owned at such time by another shareholder who then owned, or was considered as owning, more than 10 percent in value of the outstanding stock of the corporation.[3]
>
> This section of the bill adds a new subsection (m) relating to collapsible corporations, to section 117 of the Code. The collapsible corporation is a device whereby one or more individuals attempt to convert the profits from their participation in a project from income taxable at ordinary rates to long-term capital gain taxable only at a rate of 25 percent.

[1] C.B. 1950-2, 483.

[2] H. 516.

[3] H. 516-518.

Under paragraph (1) of the subsection as added to the Code, gain from the sale or exchange of stock of a collapsible corporation will be treated as gain from the sale or exchange of property which is not a capital asset. This treatment is to be effective, however, only to the extent that the use of the device is interpreted as giving rise to gain which gain is considered (but for the provisions of the subsection) as long-term capital gain.

The term "collapsible corporation" is specifically defined by paragraph (2) of the subsection to mean a corporation formed or availed of principally for the manufacture, construction, or production of property, or for the holding of stock in a corporation so formed or availed of, with a view to (i) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise) or a distribution by the corporation to its shareholders, prior to the realization by the corporation manufacturing, constructing, or producing the property of a substantial part of the net income to be derived from such property and (ii) the realization by such shareholders of gain attributable to such property. The paragraph further states when a corporation shall be deemed to have manufactured, constructed, or produced property.

It will be noted that the term "collapsible corporation" is so defined as to include corporations lending themselves to the attempted tax-saving practice outlined above, whether they are the corporations commencing and completing the project or corporations made use of as holding companies having no other business than to separate the shareholders from the corporation undertaking the project. The corporation, furthermore, has been so defined as to describe corporations different in kind from those which ordinarily liquidate following normal business operations. This

objective has been specifically strengthened by the statement made in subparagraph (1) above, to the effect that the sale or exchange or the distribution be made prior to the realization by the corporation of a substantial part of the net income to be derived from the property. Although in many cases an ordinary corporation may distribute property in-kind in the course of its liquidation, or the stock in such a corporation may be sold prior to the realization by the corporation of the net income to be derived from some of its property, such a corporation could not be considered to have been formed or availed of principally for the manufacture, construction, or production of that property, alone.

While the primary use [illegible] of collapsible corporations in the past has usually involved their liquidation in the manner indicated above, it is apparent that the shareholders forming or availing themselves of such a corporation could raise the same tax questions as would be raised by a liquidation *by selling their stock to outside interests at the time and under the circumstances when the corporation might otherwise be liquidated. In like manner, the corporation might distribute the property in question without liquidating* and, under section 115(d), the value of the property distributed, to the extent that it was not a dividend, would first be applied against the adjusted basis of the stock to the shareholders and the excess, if any, would be taxable in the same manner as a gain from the sale or exchange of property. Paragraph (1) of the subsection, in prescribing the treatment to be given the gain from the sale or exchange of stock of a collapsible corporation, is deemed to refer to this excess value in the case of a distribution made by the corporation other than in liquidation. Such a distribution is specifically referred to in connection

with the definition of the term "collapsible corporation" in paragraph (2) of the subsection. Both paragraph (1) and paragraph (2) of the subsection refer to a sale or exchange of the stock other than in liquidation. (Emphasis supplied.)

Subparagraph (B) of paragraph (2) of the subsection states that a corporation shall be deemed, for purposes of the above definition, to have manufactured, constructed, or produced property if it engaged in the manufacture, construction or production of such property to any extent or if it holds property having a substituted basis under section 113 of the Code determined by reference to the cost of property manufactured, constructed, or produced by the corporation or by another. Under this statement the corporation need not have originated the manufacture, construction, or production; neither need the manufacture, construction, or production be completed by it. It will nonetheless be deemed to have manufactured, constructed, or produced property in that its shareholders may realize gain with respect to the additional value added to the property by the manufacture, construction, or production to the extent that it was carried out. Likewise, for example, a corporation which manufactured a motion picture and exchanged it with another corporation for a motion picture manufactured by that corporation in an exchange which would not be taxable would be considered for tax purposes as having manufactured, constructed, or produced the motion picture thus received on the exchange. This latter type of provision is designed to cover an obvious device which might be utilized by a collapsible corporation in an attempt to circumvent the new provision.

Paragraph (3) of the subsection sets forth three limitations on the application of the subsection. First,

the subsection shall not apply unless the shareholder selling or exchanging his stock has at some time subsequent to the commencement of the manufacture, construction, or production of the property by the corporation owned, or been considered as owning, more than 10 percent in value of the outstanding stock of the corporation, or owned stock which was considered as owned at such time by another shareholder who then owned, or was considered as owning, more than 10 percent in value of the outstanding stock of the corporation. In determining the ownership of stock of the corporation by a shareholder, the stock ownership rules set forth in section 503(a) of the Code to the extent that they are pertinent are made applicable with the additional provision that the family of an individual shall include, in addition to the persons mentioned in that section, the spouses of that individual's brothers and sisters (whether by the whole or half-blood) and the spouses of that individual's lineal descendants. Second, the subsection shall not apply to the gain recognized by a shareholder from the sale or exchange of his stock unless more than 70 percent of such gain is attributable to the property so manufactured, constructed, or produced. Third, the subsection shall not apply to gain realized after the expiration of 3 years following the completion of the manufacture, construction, or production of the property.

It is the purpose of the first limitation to insure that the provision will only be applicable to a shareholder who, by virtue of his stock ownership, can be presumed to be an interested party to the project whether at the time of its organization or at some intermediate date. The stock ownership rules are made necessary in order to prevent any one shareholder's disguising his interest by the placement of the stock of the corporation among the different members of his family.

Both the second and third limitations relate to the *gain realized from the sale or exchange of the stock*, *the second limitation being designed to insure that the application of the subsection will be limited to those corporations where the relationship between the gain realized and the property* manufactured, *constructed* or produced *is substantial*. The third limitation imposes an arbitrary time limit beyond which gain realized will not be subject to the subsection on the theory that a corporation will not be a collapsible corporation as defined in general terms in paragraph (2) if the shareholders do not realize their gain until after 3 years following the completion of the manufacture, construction, or production. (Emphasis supplied.)

Paragraph (1) of the subsection refers to gain from the sale or exchange of a capital asset held for more than 3 months. Under section 117 of the Code, prior to its amendment by this bill, gain from the sale or exchange of a capital asset held for more than 6 months is defined as long-term capital gain. Under section 211(c) of this bill, this period would be changed to 3 months and paragraph (1) has been designed to accord with this change. It is specifically provided in subsection (b) of this section, however, that in the case of gain realized on or before the date of the enactment of this Act the words "capital asset held for more than 3 months" shall be read as "capital asset held for more than 6 months."

The success of attempts under existing law to make use of a collapsible corporation and to take advantage of the liquidation of that corporation within the meaning of section 115(c), has never been tested in the courts, and it is not clear that the individuals making use of the device will succeed in their objectives. Your committee believes, however, that the

proposed amendment dealing specifically with the subject of collapsible corporations is desirable in order to insure that the use of the device in the future will result in no tax advantage.

The amendment made by the section is applicable to taxable years ending after December 31, 1949, but only with respect to gain realized after that date. It is specifically provided in the section that the determination of the tax treatment of gains realized prior to January 1, 1950, shall be made as if this section had not been enacted and without inferences drawn from the fact that the amendment made by the section is not made applicable to such gains and without inferences drawn from the limitations contained in the subsection as added to the Code.

Internal Revenue Code of 1954
The Report of the Senate Finance Committee Dated June 18, 1954

Senate Report No. 1622, 83rd Cong. 2d Sess., is divided into two sections. The first section, consisting of pages 1 to 149, inclusive, contains a general explanation of the provisions of H. R. 8300, and the second section, pages 153 to 628, inclusive, contains a detailed discussion of the technical provisions of the bill. Under "General Explanation" and under the subheading "*(c) Current Distributions to Shareholders and Effect on Earnings and Profits*" the Report states (p. 47):

Your committee includes a provision, not in the House bill, which is designed to tax distributions of proceeds of loans insured by the United States where the amount of the loan exceeds the cost of the property by which it is secured. *This provision is intended to insure the imposition of a tax in the kind of case recently brought to attention* in connection with loans made by the Federal Housing

Administration. This provision would increase the earnings and profits of the distributing corporation by the amount of the proceeds of the loan in excess of the cost of the property securing it, and would decrease such earnings by the amount of such excess immediately after the distribution. This will have the effect of creating sufficient earnings at the time of distribution so that it may be treated as being made out of earnings and profits, that is, a dividend. Your committee emphasizes in this connection that no implication be drawn from the enactment of this provision with respect to any decision made or litigation pending under present law concerning this subject matter, whether or not such loans are made, guaranteed, or insured by the United States, *or with respect to any other provision of this bill which may be relevant to the same subject matter* (emphasis supplied).

The Senate Report, in the second section dealing with the technical provisions of the 1954 Code, and with particular reference to Section 312(j),[1] states (p. 251):

[1] As appears *infra*, p. 49a this refers to Section 311(a)(3).

[2] From Internal Revenue Code of 1954:

§312. Effect on Earnings and Profits

* * * * * * *

(j) Distribution of proceeds of loan insured by the United States.—

(1) In general.—If a corporation distributes property with respect to its stock, and if, at the time of the distribution—

(A) there is outstanding a loan to such corporation which was made, guaranteed, or insured by the United States (or by any agency or instrumentality thereof), and

(B) the amount of such loan so outstanding exceeds the adjusted basis of the property constituting security for such loan,

then the earnings and profits of the corporation shall be increased by the amount of such excess and (immediately after the distribution) shall be decreased by the amount of such

Subsection (j) which has no counterpart in the House bill relates to the adjustment of earnings and profits on account of the distribution of proceeds of a loan insured by the United States. It provides that when property is distributed, the earnings and profits shall be increased by the excess of United States Government insured loans outstanding over the adjusted basis of the property, determined without regard to any adjustment under Section 1016(a)(2) relating to the depreciation, etc., upon distributions of property by the corporation. It is intended that the property distributed not be restricted to the loan proceeds, but includes any distribution, whether or not equal in amount to the excess of the loan over the adjusted basis.

To the extent that any distribution exceeds the excess of the loan over the adjusted basis, earnings and profits not rising out of the increase herein provided may be decreased, and if no other earnings and profits are available, the capital may be decreased. It is intended that as long as such loan is outstanding, the value of any distribution shall be treated as a dividend to the shareholder to the extent that it does not exceed the excess of the loan over the adjusted basis. In no case may an accumulated deficit in earnings and profits of the corporation be used to reduce the increase in earnings and profits to be made under this section.

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excess. For purposes of subparagraph (B) of the preceding sentence, the adjusted basis of the property at the time of distribution shall be determined without regard to any adjustment under section 1016(a)(2) (relating to adjustment for depreciation, etc.). For purposes of this paragraph, a commitment to make, guarantee, or insure a loan shall be treated as the making, guaranteeing, or insuring of a loan.

(2) Effective date. Paragraph (1) shall apply only with respect to distributions made on or after June 22, 1954.

It is intended that the subsection shall apply with respect to a loan made, guaranteed, or insured by any agency or instrumentality of the United States, including the Federal Housing Administration. For this purpose, a commitment to guarantee or insure a loan shall be treated as the making, guaranteeing, or insuring of a loan. The subsection applies to distributions made on or after June 18, 1954, without regard to when the loans may have been guaranteed, or insured by the United States.

Your committee intends that no implication be drawn from the enactment of this subsection with respect to any decision made or litigation pending under present law with respect to this subject matter, whether or not such loans are made, guaranteed, or insured by the United States, *or with respect to any other provision of this bill which may be relevant to the same subject matter, such as section 341, relating to collapsible corporations* (emphasis supplied).

In discussing the technical provisions of the 1954 Code, with particular reference to Section 341(a), the Senate Report states (pp. 260-261):

"*Section 341. Collapsible corporations.*

Your committee has revised the solution to the collapsible corporation problem which appears in the House bill. Under the House bill, so-called appreciated inventory retains its basis in the hands of the corporation in the event of liquidation and a tax on its full appreciation is recovered at the time of its disposition. The House bill permits sales of stock of what would be characterized as a collapsible corporation under existing law to be effected with capital-gain consequences to the selling shareholder.

Your committee's approach to the collapsible corporation problem is to return to existing law and to

continue Section 117(m) for the future. *Your committee writes into the section a provision now appearing in the regulations under this section and makes two substantial changes with a view to strengthening its effectiveness.* (Emphasis supplied.)

Subsection (a)(3), *incorporates a rule of present regulations* that would include gain from a distribution made by a collapsible corporation which under Section 301(c)(3)(A) is treated (to the extent it exceeds stock basis) as a gain from the sale or exchange of property and would provide that such excess be treated as the gain from the sale of property which is not a capital asset. This provision would apply, for example, in the case of a corporation engaged in building, and otherwise meeting the tests of a collapsible corporation, *which distributes the proceeds of a loan in excess* of the adjusted basis of the property by which the loan is secured. *This rule supplements that previously described which appears in Section 312(i)* of your committee's bill, relating to loans insured by the *United States. Just as under section 312(i), no inference is intended with respect to the status of present law by reason of the insertion into the statute of this rule* (emphasis supplied).

The Senate's entirely new provisions of Subchapter C of H. R. 8300 (which ultimately became the 1954 Revenue Code) appeared as Senate Amendment No. 82, and was considered by conferees of the House and the Senate. The Conference Report of July 26, 1954, (Report No. 2543, 83rd Cong. 2d Sess.) at page 34, discloses that the House conferees agreed to the Senate amendment except for certain clerical, technical and conforming amendments, none of which are important here.

No. 458

In the Supreme Court of the United States

OCTOBER TERM, 1960

R. A. BRYAN AND RUBY M. BRYAN, C. E. MCNARY AND ROWENA A. MCNARY, W. H. WEAVER AND EDITH H. WEAVER, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

J. LEE RANKIN,
Solicitor General,

CHARLES K. RICE,
Assistant Attorney General,

HARRY BAUM,
Special Assistant to the Attorney General,

Department of Justice, Washington, D.C.

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In the Supreme Court of the United States

OCTOBER TERM, 1960

No. 453

R. A. BRYAN AND RUBY M. BRYAN, C. B. MCNAIRY AND ROWENA A. MCNAIRY, W. H. WEAVER AND EDITH H. WEAVER, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The Tax Court's opinion relating to taxpayers Bryan and McNairy (R. 4–49)[1] is reported at 32 T.C. 104, and its opinion relating to taxpayer Weaver (R. 50–88) is reported at 32 T.C. 411. The opinion of the court of appeals (Pet. 17a–26a) is reported at 281 F. 2d 238.

JURISDICTION

The judgment of the court of appeals was entered on July 13, 1960 (Pet. 16a). The petition for a writ

[1] "Taxpayers" refers to R. A. Bryan, C. B. McNairy, and W. H. Weaver. Their wives are parties only because joint returns were filed. Record references are to the appendix to the taxpayers' brief in the court of appeals.

of certiorari was filed on September 29, 1960. The jurisdiction of this Court is invoked under 28 U.S.C. 1254.

QUESTION PRESENTED

Whether the record supports the holdings of both courts below that two corporations in which the taxpayers were stockholders were collapsible corporations within Section 117(m) of the Internal Revenue Code of 1939, and that therefore gain realized by them upon the redemption of some of their stock in the corporations was taxable as ordinary income rather than as capital gain.

STATUTE AND REGULATIONS INVOLVED

The relevant provisions of Section 117(m) of the Internal Revenue Code of 1939 and Section 29.117–11 of Treasury Regulations 111 are set out in the Appendix, *infra*, pp. 11–27.

STATEMENT

The relevant facts as found by the Tax Court (R. 6–22, 51–66) and by the court of appeals (Pet. 18a–19a) may be summarized as follows:

Two construction companies, T. A. Loving & Company, controlled by taxpayers Bryan and McNairy and others, and W. H. Weaver Construction Company, controlled by taxpayer Weaver, formed a joint venture to bid upon certain Wherry Act housing projects to be constructed at the Fort Bragg Military Reservation, North Carolina. Through two corporations organized in 1950 for this purpose, Bragg Investment Company, Inc., and Bragg Development Company, Inc. (hereinafter referred to respectively as Investment

and Development), the taxpayers constructed four separate housing projects with F.H.A. insured loans aggregating $15,687,000. Investment and Development each issued 100 shares of preferred stock to the F.H.A. and 300 shares of Class A common stock for cash at $1 par value per share, with 60 shares issued to McNairy, 150 shares issued to Weaver, and 90 shares issued to Bryan.

The insured loans were obtained upon F.H.A. estimates of replacement costs of the projects. These estimates included items for architect fees in the amount of $834,356. After F.H.A. insured loans had been procured, and in line with the estimates in the loan applications, Class B common stock with an aggregate par value of $834,356 was issued to Seward H. Mott, an architect. In addition to the stock, Mott received $8,000 in cash. Previously Mott had agreed to do the work for $42,605.62. Upon receipt of the stock Mott promptly sold his stock, having a face value of $834,356, to the taxpayers for $44,605.62. The two corporations, Investment and Development, then redeemed a portion of the stock formerly held by Mott at par from the taxpayers for $618,368.

In their 1951 and 1953 income tax returns, the taxpayers reported these receipts on redemptions of the Class B stock of Investment and Development as long-term capital gains after deducting their payments to Mott as their claimed cost basis of the Class B common stock. The Commissioner determined that the full amount received upon redemption of the stock constituted ordinary income within the provisions of Section 22(a) and Section 117(m) of the Internal

Revenue Code of 1939. The Tax Court found and held (R. 22, 33–39, 66, 75) that Investment and Development were "collapsible corporations" as defined in Section 117(m), and that the gains were taxable as ordinary income. The court of appeals affirmed (Pet. 18a–20a).[2]

ARGUMENT

The decision below, affirming that of the Tax Court, is clearly correct. There is no conflict of decisions or other reason for further review of this case.

Section 117(m) of the Internal Revenue Code of 1939 (see the Appendix, *infra*, pp. 11–13) provides that "[g]ain from the sale or exchange * * * of stock of a collapsible corporation, to the extent that it would be considered (but for the provisions of this subsection) as gain from the sale or exchange of a capital asset held for more than 6 months, shall [with certain exceptions] be considered as gain from the sale or exchange of property which is not a capital asset." The redemption distributions here involved—consisting of excess proceeds of F.H.A. insured mortgage loans over the costs of construction—are the very type which Section 117(m) was designed to cover. In a series of similar cases the lower courts have held the statute to be applicable. In fact, as the court below pointed out (Pet. 20a), the situation in the present case is "quite indistinguishable" from that of *Spangler* v. *Commissioner*, 278 F. 2d 665 (C.A. 4), certiorari denied, October 10, 1960. See also *Burge* v. *Commissioner*, 253 F. 2d 765 (C.A. 4); *Weil* v. *Commissioner*,

[2] The case was ordered remanded to the Tax Court for further proceedings as to a different issue (Pet. App. 18a).

252 F. 2d 805 (C.A. 2); *Glickman* v. *Commissioner*, 256 F. 2d 108 (C.A. 2); *Sorin* v. *Commissioner*, 271 F. 2d 741 (C.A. 2); *Sidney* v. *Commissioner*, 273 F. 2d 928 (C.A. 2); *Mintz* v. *Commissioner* (C.A. 2), decided November 17, 1960; *Abbott* v. *Commissioner*, 258 F. 2d 537 (C.A. 3); *August* v. *Commissioner*, 267 F. 2d 829 (C.A. 3); *Payne* v. *Commissioner*, 268 F. 2d 617 (C.A. 5). Each of the arguments which the taxpayers assert has been rejected in one or more of these cases.

1. Taxpayers' contention (Pet. 19-21) that the decision below conflicts with *Jacobson* v. *Commissioner*, 281 F. 2d 703 (C.A. 3), seeks to raise an issue not litigated in the court below. The decision in *Jacobson* turned on whether the "view" requirement of Section 117(m)(2) (Appendix, *infra*, p. 11) had been met. That subsection defines a "collapsible corporation" as "a corporation formed or availed of principally for the manufacture, construction, or production of property * * * with a view to — (i) the sale or exchange of stock by its shareholders * * * or a distribution to its shareholders, prior to the realization by the corporation * * * of a substantial part of the net income to be derived from such property, and (ii) the realization by such shareholders of gain attributable to such property." In the instant case, the taxpayers did not challenge the Tax Court's findings (R. 35-37) that the requisite "view" existed prior to completion of construction, and accordingly, the court below did not consider or pass upon the question. Having failed to raise the issue in the court below, taxpayers may not do so in the petition for certiorari.

Zellerbach v. *Helvering*, 293 U.S. 177, 182; *Lawn* v. *United States*, 355 U.S. 339, 362, fn. 16; *Duignan* v. *United States*, 274 U.S. 195, 200.

In any event, there is plainly no conflict between *Jacobson* and the present case. In dicta in two prior decisions of the Second and Fourth Circuits (*Glickman* v. *Commissioner*, *supra*, 256 F. 2d at 111, and *Burge* v. *Commissioner*, *supra*) the interpretation of the statutory "view" requirement contained in the Treasury Regulations (Section 29.117–11(b) of Regulations 111, Appendix, *infra*, pp. 14–16) was criticized as overly liberal in favor of taxpayers. These courts stated that, while the Regulations required that the view exist at some time "during the construction" or that the sale, exchange, or distribution be attributable "to circumstances which reasonably could be anticipated [at] the time of such * * * construction," the statute requires only that the view exist when the corporation is "availed of" for the purposes stated in Section 117(m). In *Jacobson*, the Third Circuit disagreed with these dicta,[3] but expressly upheld the interpretation of the "view" requirement in the Regulations, *i.e.*, that the requisite view may exist at any time during construction. See also *Weil* v. *Commissioner*, *supra*; *August* v. *Commissioner*, *supra*; *Sidney* v. *Commissioner*, *supra*; *Payne* v. *Commissioner*, *supra*. The Third Circuit reversed the Tax Court solely on the ground that there was "simply no substantial evidentiary basis" for its conclusion that

[3] The criticisms constituted dicta since the courts of appeals upheld the Tax Court's holdings in favor of the Commissioner on the basis of the Regulations, the same basis used by the Tax Court.

the taxpayers anticipated selling their stock prior to completion of construction. 281 F. 2d at 707. Since here, unlike *Jacobson*, the necessary "view" existed before or, at the least, during the construction, the asserted conflict with *Jacobson* manifestly reflects merely a difference in factual situations, rather than any disagreement as to applicable principles.[4]

2. Taxpayers contend (Pet. 22–28) that Section 117(m) is aimed solely at a distribution which results in complete liquidation of the corporation, or a sale of all of its stock to outsiders, or distribution of property of a corporation in kind, but not also at a cash distribution in redemption of part of the stock. This argument, however, runs directly counter to the language of that section and to its underlying purpose, as revealed by its legislative history and as expounded by the courts. It is simply a reiteration of essentially the same argument that has heretofore been rejected by every court which has passed upon the problem.

[4] In *Jacobson*, the court of appeals concluded that the sale was induced by the discovery, after completion of construction, of a crack in one of the buildings. In the present case, on the other hand, the evidence shows that the stock redemption was part of a single planned transaction initiated even prior to construction. Thus, the consideration which architect Mott was to receive ($52,605.62) was fixed before the incorporation of Investment and Development. Around the time construction commenced, in line with estimates in F.H.A. loan applications, Class B stock, having an aggregate par value of $34,356, was issued to the architect (in addition to $8,000 in cash), who promptly sold his stock to the taxpayers for $44,605.62. The corporations subsequently redeemed a portion of this stock from the taxpayers for $618,268 (see R. 11, 14, 19–20; Pet. 19a). Cf. *Payne* v. *Commissioner*, *supra*, 268 F. 2d at 620–621; *August* v. *Commissioner*, *supra*, 267 F. 2d at 834.

See, *e.g.*, *Spangler* v. *Commissioner*, *supra*, 278 F. 2d at 672; *Burge* v. *Commissioner*, *supra*, 253 F. 2d at 769; *Glickman* v. *Commissioner*, *supra*, 256 F. 2d at 110; *Mintz* v. *Commissioner*, *supra*. While cases involving complete liquidation of a corporation were prominent in the discussions preceding the enactment of Section 117(m), Congress realized that the abuse which it sought to remedy could take other forms. Accordingly, the "collapsible corporation" definition (Section 117(m)(2)(A)) was "drawn in broad general terms" (*Burge* v. *Commissioner*, *supra*, 253 F. 2d at 767), and it explicitly embraces "the sale or exchange of stock by its shareholders (whether in liquidation or otherwise) or a distribution to its shareholders." See also H. Rep. No. 2319, 81st Cong., 2d Sess., p. 97 (1950-2 Cum. Bull. 380, 449–450); S. Rep. No. 2375, 81st Cong., 2d Sess., p. 89 (1950-2 Cum. Bull. 483, 546–547). The "distributions" here involved—in redemption of portions of taxpayers' Class B stock—unquestionably fall within the purview of the statute.

3. Equally untenable is taxpayers' contention (Pet. 27–30) that the implementing Treasury Regulations (Section 29.117–11 of Regulations 111) transcend the provisions of Section 117(m) by treating as ordinary income gains from corporate distributions which previously had been taxable as capital gains under Section 115(d) of the 1939 Code (26 U.S.C. (1952 ed.) 115(d)). In fact, the Regulations are in complete harmony with the broad provisions of Section 117(m) and their legislative history, and have been sustained by every court which has passed upon their validity. At any rate, the decision here need not turn on the

interpretative Regulations; it is sustained by the statutory provisions themselves, to say nothing of the explanatory Committee Reports. Section 117(m)(1) expressly provides that it covers gains which "but for the provisions of this subsection," would be capital gains. Moreover, contrary to the taxpayers' assertions, the Committee Reports point out that Section 117(m) was intended to cover distributions which previously were taxable as capital gains under Section 115(d). See H. Rep. No. 2319, *supra*, p. 97 (1950–2 Cum. Bull. 380, 450); S. Rep. No. 2375, *supra*, p. 89 (1950–2 Cum. Bull. 483, 547). See also *Spangler* v. *Commissioner*, *supra*, 278 F. 2d at 672–673.

4. Nor is there any substance in taxpayers' suggestion (Pet. 28–29) that the Congress which enacted the corresponding provisions of the 1954 Code (Section 341), considered the Regulations promulgated under Section 117(m) of the 1939 Code to be invalid. On the contrary, it appears that Congress went to considerable length to indicate otherwise since the Committee Report on the 1954 Code explicitly disavows any inference that the previous Regulations were invalid. S. Rep. No. 1622, 83d Cong., 2d Sess., p. 260 (3 U.S.C. Cong. & Adm. News (1954) 4621, 4898). See also Section 312(j) of the 1954 Code; S. Rep. No. 1622, *supra*, p. 47.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that the petition for a writ of certiorari should be denied.

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DECEMBER 1960.

APPENDIX

Internal Revenue Code of 1939:

SEC. 117. CAPITAL GAINS AND LOSSES.

* * * * * * *

(m) [as added by Sec. 212(a) of the Revenue Act of 1950, c. 994, 64 Stat. 906] *Collapsible Corporations.*—

(1) *Treatment of gain to shareholders.*—Gain from the sale or exchange (whether in liquidation or otherwise) of stock of a collapsible corporation, to the extent that it would be considered (but for the provisions of this subsection) as gain from the sale or exchange of a capital asset held for more than 6 months, shall, except as provided in paragraph (3), be considered as gain from the sale or exchange of property which is not a capital asset.

(2) *Definitions.*—

(A) For the purposes of this subsection, the term "collapsible corporation" means a corporation formed or availed of principally for the manufacture, construction, or production of property, or for the holding of stock in a corporation so formed or availed of, with a view to—

(i) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, prior to the realization by the corporation manufacturing, constructing, or producing the property of a substantial part of the net income to be derived from such property, and

(ii) the realization by such shareholders of gain attributable to such property.

(B) For the purposes of subparagraph (A), a corporation shall be deemed to have manufactured, constructed, or produced property, if—

(i) it engaged in the manufacture, construction, or production of such property to any extent,

(ii) it holds property having a basis determined, in whole or in part, by reference to the cost of such property in the hands of a person who manufactured, constructed, or produced the property, or

(iii) it holds property having a basis determined, in whole or in part, by reference to the cost of property manufactured, constructed, or produced by the corporation.

(3) *Limitations on application of subsection.*—In the case of gain realized by a shareholder upon his stock in a collapsible corporation—

(A) this subsection shall not apply unless, at any time after the commencement of the manufacture, construction, or production of the property, such shareholder (i) owned (or was considered as owning) more than 10 per centum in value of the outstanding stock of the corporation, or (ii) owned stock which was considered as owned at such time by another shareholder who then owned (or was considered as owning) more than 10 per centum in value of the outstanding stock of the corporation;

(B) this subsection shall not apply to the gain recognized during a taxable year unless more than 70 per centum of such gain is attributable to the property so manufactured, constructed, or produced; and

(C) this subsection shall not apply to gain realized after the expiration of three

years following the completion of such manufacture, construction, or production. For purposes of subparagraph (A), the ownership of stock shall be determined in accordance with the rules prescribed by paragraphs (1), (2), (3), (5), and (6) of section 503(a), except that, in addition to the persons prescribed by paragraph (2) of that section, the family of an individual shall include the spouses of that individual's brothers and sisters (whether by the whole or half blood) and the spouses of that individual's lineal descendants.

* * * * *

(26 U.S.C. (1952 ed.) 117)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

Sec. 29.117-11 [as added by T.D. 5999, 1953-1 Cum. Bull. 187]. *Collapsible Corporations.*—(*a*) *In general.*—With respect to taxable years ending after December 31, 1949, but only with respect to gain realized after such date, and subject to the limitations contained in (*c*) hereof, the entire gain from (1) the actual sale or exchange of stock of a collapsible corporation, (2) amounts distributed in complete or partial liquidation of a collapsible corporation which are treated, under section 115(c), as payment in exchange for stock, and (3) a distribution made by a collapsible corporation which, under section 115(d), is treated, to the extent it exceeds the basis of the stock, in the same manner as a gain from the sale or exchange of property, shall be considered as gain from the sale or exchange of property which is not a capital asset.

(*b*) *Determination of collapsible corporation.*—With respect to taxable years ending after December 31, 1949, but only with respect to gain realized after such date, a collapsible corporation is defined by section 117(m)(2)

(A) to be a corporation formed or availed of principally for the manufacture, construction, or production of property, or for the holding of stock in a corporation so formed or availed of, with a view to (1) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, prior to the realization by the corporation manufacturing, constructing, or producing the property of a substantial part of the net income to be derived from such property, and (2) the realization by such shareholders of gain attributable to such property. With respect to taxable years ending after August 31, 1951, but only with respect to gain realized after such date, the definition of a collapsible corporation under section 117(m)(2)(A) is expanded to include a corporation formed or availed of principally for the purchase of property which (in the hands of the corporation) is property described in section 117(a)(1)(A), or for the holding of stock in a corporation so formed or availed of, with a view to (1) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, prior to the realization by the corporation purchasing the property of a substantial part of the net income to be derived from such property, and (2) the realization by such shareholders of gain attributable to such property.

See (*d*) of this section for a description of the facts which will ordinarily be considered sufficient to establish whether or not a corporation is a collapsible corporation under the rules of the section. See (*e*) of this section for example of the application of section 117(m).

Under section 117(m)(2)(A), the corporation must be formed or availed of with a view to the action therein described, that is, the sale or exchange of its stock by its shareholders, or

a distribution to them, prior to the realization by the corporation manufacturing, constructing, producing, or purchasing the property of a substantial part of the net income to be derived from such property, and the realization by the shareholders of gain attributable to such property. This requirement is satisfied in any case in which such action was contemplated by those persons in a position to determine the policies of the corporation, whether by reason of their owning a majority of the voting stock of the corporation or otherwise. The requirement is satisfied whether such action was contemplated unconditionally, conditionally, or as a recognized possibility. If the corporation was so formed or availed of, it is immaterial that a particular shareholder was not a shareholder at the time of the manufacture, construction, production, or purchase of the property; or if a shareholder at such time, did not share in such view, and any gain of such shareholder on his stock in the corporation shall be treated in the same manner as gain of a shareholder who did share in such view. See, however, the limitation contained in (*e*)(2) hereof. The existence of a bona fide business reason for doing business in the corporate form does not, by itself, negate the fact that the corporation may also have been formed or availed of with a view to the action described in section 117(m)(2)(A).

A corporation is formed or availed of with a view of the action described in section 117(m)(2)(A) if the requisite view existed at any time during the manufacture, production, construction, or purchase referred to in that section. Thus, if the sale, exchange, or distribution is attributable solely to circumstances which arose after the manufacture, construction, production, or purchase (other than circumstances which reasonably could be anticipated at the time of such manufacture, construction, production, or purchase), the corporation shall, in the absence

of compelling facts to the contrary, be considered not to have been so formed or availed of. However, if the sale, exchange, or distribution is attributable to circumstances present at the time of the manufacture, construction, production, or purchase, the corporation shall, in the absence of compelling facts to the contrary, be considered to have been so formed or availed of.

The property referred to in section 117(m)(2)(A) is that property or the aggregate of those properties with respect to which the requisite view existed. In order to ascertain the property or properties as to which the requisite view existed, reference shall be made to each property as to which, at the time of the sale, exchange, or distribution referred to in section 117(m)(2)(A), there has not been a realization by the corporation manufacturing, constructing, producing, or purchasing the property of a substantial part of the net income to be derived from such property. However, where any such property is a unit of an integrated project involving several properties similar in kind, the determination whether the requisite view existed shall be made only if a substantial part of the net income to be derived from the project has not been realized at the time of the sale, exchange, or distribution, and in such case the determination shall be made by reference to the aggregate of the properties constituting the single project.

A corporation shall be deemed to have manufactured, constructed, produced, or purchased property if it (1) engaged in the manufacture, construction, or production of property to any extent, or (2) holds property having a basis determined, in whole or in part, by reference to the cost of such property in the hands of a person who manufactured, constructed, produced, or purchased the property, or (3) holds property having a basis determined, in whole or in

part, by reference to the cost of property manufactured, constructed, produced, or purchased by the corporation. Thus, under (1), for example, a corporation need not have originated nor have completed the manufacture, construction, or production of the property. Under (2), for example, if an individual were to transfer property constructed by him to a corporation in exchange for all of the capital stock of such corporation, and such transfer qualifies under section 112(b)(5), then the corporation would be deemed to have constructed the property, since the basis of the property in the hands of the corporation would, under section 113(a)(8), be determined by reference to the basis of the property in the hands of the individual. Under (3), for example, if a corporation were to exchange property constructed by it for property of like kind constructed by another person, and such exchange qualifies under section 112(b)(1), then the corporation would be deemed to have constructed the property received by it in the exchange since the basis of the property received by it in the exchange would, under section 113(a)(6), be determined by reference to the basis of the property constructed by the corporation.

In determining whether a corporation is a collapsible corporation by reason of the purchase of property, it is immaterial whether the property is purchased from the shareholders of the corporation or from persons other than such shareholders. The property, however, must be property which, in the hands of the corporation, is property of a kind described in section 117(a)(1)(A). Section 117(a)(1)(A) describes the following property: stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the

ordinary course of its trade or business. The determination whether property is of a kind described in section 117(a)(1)(A) shall be made without regard to the fact that the corporation is formed or availed of with a view to the action described in section 117(m)(2)(A).

Section 117(m) is applicable whether the shareholder is an individual, a trust, an estate, a partnership, a company, or a corporation.

(c) *Limitations on application of section.*—(1) *General.*—This section shall apply only to the extent that the recognized gain of a shareholder upon his stock in a collapsible corporation would be considered, but for the provisions of this section, as gain from the sale or exchange of a capital asset held for more than 6 months. Thus, if a taxpayer sells at a gain stock of a collapsible corporation which he has held for 6 months or less, this section would not, in any event, apply to such gain. Also, if it is determined, under provisions of law other than section 117(m), that a sale or exchange at a gain of stock of a collapsible corporation which has been held for more than 6 months results in ordinary income rather than long-term capital gain, then this section (including the limitations contained herein) has no application whatsoever to such gain.

(2) *Stock ownership rules.*—This section shall apply in the case of gain realized by a shareholder upon his stock in a collapsible corporation only if the shareholder, at any time after the actual commencement of the manufacture, construction, or production of the property, or at the time of the purchase of the property described in section 117(a)(1)(A) or at any time thereafter, (i) owned, or was considered as owning, more than 10 percent in value of the outstanding stock of the corporation, or (ii) owned stock which was considered as owned at such time by another shareholder who then owned, or was considered as owning,

more than 10 percent in value of the outstanding stock of the corporation.

The ownership of stock shall be determined in accordance with the rules prescribed by section 503(a) (1), (2), (3), (5), and (6), except that, in addition to the persons prescribed by section 503(a)(2), the family of an individual shall include the spouses of that individual's brothers and sisters, whether such brothers and sisters are by the whole or the half blood, and the spouses of that individual's lineal descendants.

For the purpose of this limitation, treasury stock shall not be considered as outstanding stock.

It is possible, under this limitation, that a shareholder in a collapsible corporation may have gain upon his stock in that corporation treated differently from the gain of another shareholder in the same collapsible corporation.

(3) *Seventy-percent rule.*—This section shall apply to the gain recognized during a taxable year upon the stock in a collapsible corporation only if more than 70 percent of such gain is attributable to the property referred to in section 117(m)(2)(A). If more than 70 percent of such gain is so attributable, then all of such gain is subject to this section, and, if 70 percent or less of such gain is so attributable, then none of such gain is subject to this section.

For the purpose of this limitation, the gain attributable to the property referred to in section 117(m)(2)(A) is the excess of the recognized gain of the shareholder during the taxable year upon his stock in the collapsible corporation over the recognized gain which the shareholder would have if the property had not been manufactured, constructed, produced, or purchased. In the case of gain on a distribution in partial liquidation or a distribution described in section 115(d), the gain attributable to the property shall not be less than an amount which

bears the same ratio to the gain on such distribution as the gain which would be attributable to the property if there had been a complete liquidation at the time of such distribution bears to the total gain which would have resulted from such complete liquidation.

Gain may be attributable to the property referred to in section 117(m)(2)(A) even though such gain is represented by an appreciation in the value of property other than that manufactured, constructed, produced, or purchased. Where, for example, a corporation owns a tract of land and the development of one-half of the tract increases the value of the other half, the gain attributable to the developed half of the tract includes the increase in the value of the other half.

(4) *Three-year rule.*—This section shall not apply to that portion of the gain of a shareholder that is realized more than 3 years after the actual completion of the manufacture, construction, production, or purchase of the property to which such portion is attributable.

(*d*) *Application of section.*—(1) Whether or not a corporation is a collapsible corporation shall be determined under the rules of (*b*) of this section on the basis of all the facts and circumstances in each particular case. The following paragraphs set forth those facts which will ordinarily be considered sufficient to establish that a corporation is or is not a collapsible corporation. The facts set forth in the following paragraphs are not exclusive of other facts which may be controlling in any particular case. For example, if the facts in paragraph (2), but not the facts in paragraph (3), are present, the corporation may nevertheless not be a collapsible corporation if there are other facts which clearly establish that the rules of (*b*) of this section are not satisfied. Similarly, if the facts in paragraph (3) are present, the corporation may nevertheless be

a collapsible corporation if there are other facts which clearly establish that the corporation was formed or availed of in the manner described in (*b*) of this section, or if the facts in paragraph (3) are not significant by reason of other facts, such as the fact that the corporation is subject to the control of persons other than those who were in control immediately prior to the manufacture, construction, production, or purchase of the property.

See (*c*) of this section for provisions which make section 117(m) inapplicable to certain shareholders of collapsible corporations.

(2) The following facts will ordinarily be considered sufficient (except as otherwise provided in paragraph (1), above, and paragraph (3), below) to establish that a corporation is a collapsible corporation:

(i) A shareholder of the corporation sells or exchanges his stock, or receives a liquidating distribution, or a distribution described in section 115(d),

(ii) Upon such sale, exchange, or distribution, such shareholder realizes gain attributable to the property described below, and

(iii) At the time of the manufacture, construction, production, or purchase of the property described below, such activity was substantial in relation to the other activities of the corporation which manufactured, constructed, produced, or purchased such property.

The property referred to above is that property or the aggregate of those properties which meet the following two requirements:

(iv) The property is manufactured, constructed, or produced by the corporation or by another corporation stock of which is held by the corporation, or is property purchased by the corporation or by such other corporation which (in the hands of the cor-

poration holding such property) is property described in section 117(a)(1)(A) (relating to stock in trade, inventories, and property held primarily for sale to customers), and

(v) At the time of the sale, exchange, or distribution described in (i) above, the corporation which manufactured, constructed, produced, or purchased such property has not realized a substantial part of the net income to be derived from such property.

In the case of property which is a unit of an integrated project involving several properties similar in kind, the rules of this paragraph shall be applied to the aggregate of the properties constituting the single project rather than separately to such unit. Under the rules of this paragraph, a corporation shall be considered a collapsible corporation by reason of holding stock in other corporations which manufactured, constructed, produced, or purchased the property only if the activity of the corporation in holding stock in such other corporations is substantial in relation to the other activities of the corporation.

(3) The absence of any of the facts set forth in paragraph (2) or the presence of the following facts will ordinarily be considered sufficient (except as otherwise provided in paragraph (1), above) to establish that a corporation is not a collapsible corporation:

(i) In the case of a corporation subject to the rules of paragraph (2) only by reason of the manufacture, construction, production, or purchase (either by the corporation or by another corporation the stock of which is held by the corporation) of property which is property described in section 117(a)(1)(A), the amount (both in quantity and value) of such property is not in excess of the amount which is normal—

(A) For the purpose of the business activities of the corporation which manufactured, constructed, produced, or purchased the property if such corporation has a substantial prior business history involving the use of such property and continues in business, or

(B) For the purpose of an orderly liquidation of the business if the corporation which manufactured, constructed, produced, or purchased such property has a substantial prior business history involving the use of such property and is in the process of liquidation.

(iii) In the case of a corporation subject to the rules of paragraph (2) with respect to the manufacture, construction, or production (either by the corporation or by another corporation the stock of which is held by the corporation) of property, the amount of the unrealized net income from such property is not substantial in relation to the amount of the net income realized (after the completion of a material part of such manufacture, construction, or production, and prior to the sale, exchange, or distribution referred to in paragraph (2)(i)) from such property and from other property manufactured, constructed, or produced by the corporation.

(c) *Examples.* The following examples will illustrate the application of this section:

Example (1). On January 2, 1951, A formed the W Corporation and contributed $50,000 cash in exchange for all of the stock thereof. The W Corporation borrowed $900,000 from a bank, the loan being insured by the Federal Housing Authority, and used $850,000 of such sum in the construction of an apartment house on land which it purchased for $50,000. The apartment house was completed on December 31, 1951. On December 31, 1951, the corpora-

tion, having determined that the fair market value of the apartment house, separate and apart from the land, was $900,000, made a distribution (permitted under the applicable state law) to A of $100,000. At this time, the fair market value of the land was $50,000. As of December 31, 1951, the corporation has not realized any earnings and profits. In 1952, the corporation began the operation of the apartment house and received rentals therefrom. The corporation has since continued to own and operate the building. The corporation reported on the basis of the calendar year and cash receipts and disbursements.

Since A received a distribution and realized a gain attributable to the building constructed by the corporation, since, at the time of such distribution, the corporation has not realized a substantial part of the net income to be derived from such building, and since the construction of the building was a substantial activity of the corporation, the W Corporation is considered a collapsible corporation under (*d*)(2) of this section. The provisions of section 117(m)(3) do not prohibit the application of section 117(m)(1) to A. Therefore, the distribution, if and to the extent that it may be considered long-term capital gain rather than ordinary income without regard to section 117(m), will be considered ordinary income under section 117(m)(1).

In the event of the existence of additional facts and circumstances in the above case, the corporation, notwithstanding the above facts, might not be considered a collapsible corporation. See (*b*) and (*d*)(1) of this section.

Example 2. On January 2, 1950, B formed the X Corporation and became the sole shareholder thereof. This corporation completed the construction of an office building in 1950. Immediately after the completion of the building, the corporation sold this building at a gain of

$50,000, included this entire gain in its return for 1950, and distributed this entire gain (less taxes) to B. The corporation completed the construction of a second office building in June 1951. In August 1951, B sold the entire stock of the X Corporation at a gain of $12,000, which gain is attributable to the second building. In view of the fact that B sold stock of the X corporation and realized a gain attributable to the second office building, that, at the time of such sale, the corporation had not realized a substantial part of the net income to be derived from such building, and that the construction of such building during the time of such construction was a substantial activity of the corporation, the X Corporation is considered a collapsible corporation under (*d*)(2) of this section. Since the provisions of section 117(m)(3) do not prohibit the application of section 117(m)(1) to B, the gain of $12,000 to B is, accordingly, considered ordinary income.

Example (3). The facts in this example are the same as in example (2), except that the following facts are shown: B was the president of the X Corporation and active in the conduct of its business. The second building was constructed as the first step in a project of the X Corporation for the development for rental purposes of a large suburban center involving the construction of several buildings by the corporation. The sale of the stock by B was caused by his retiring from all business activity as a result of illness arising after the second building was constructed. Under these additional facts, the corporation is not considered a collapsible corporation. See (*b*) and (*d*)(1) of this section.

Example (4). On January 2, 1947, C formed the Y Corporation and became the sole shareholder thereof. The Y Corporation has been engaged solely in the business of producing motion pictures and licensing their exhibition.

On January 2, 1952, C sold all of the stock of the Y Corporation at a gain. The Y Corporation has produced one motion picture each year since its organization and prior to January 2, 1952, it has realized a substantial part of the net income to be derived from each of its motion pictures except the last one made in 1951. This last motion picture was completed September 1, 1951. As of January 2, 1952, no license had been made for its exhibition. The fair market value on January 2, 1952, of this last motion picture exceeds the cost of its production by $50,000. A material part of the production of this last picture was completed on January 1, 1951, and between that date and January 2, 1952, the corporation had realized net income of $500,000 from other motion pictures produced by it. The corporation has consistently distributed to its shareholder its net income when received (after adjustment for taxes).

Although the corporation is within (*d*)(2) of this section with respect to the production of property, the amount of the unrealized net income from such property ($50,000) is not substantial in relation to the amount of the net income realized, after the completion of a material part of the production of such property and prior to sale of the stock, from such property and other property produced by the corporation ($500,000). Accordingly, the Y Corporation is within (*d*)(3)(ii) of this section, and is not considered a collapsible corporation.

Example (5). The facts are the same as in example (*4*) except that C sold all of his stock to D on February 1, 1951. On January 2, 1952, D sold all of the Y Corporation stock at a gain, the gain being attributable to the picture completed September 1, 1951, and not released by the corporation for exhibition. In view of the change of control of the corporation, the provisions of (*d*)(3)(ii) are not significant at the time of the sale by D, and the Y Corporation

would be considered a collapsible corporation on January 2, 1952. See (*b*) and (*d*)(1) of this section.

Section 39.117–11 of Treasury Regulations 118, promulgated under the Internal Revenue Code of 1939, effective for the taxable years beginning with 1952, is similar to Section 29.117–11 of Treasury Regulations 111.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1960

No. 453

H. A. BRYAN AND RUBY M. BRYAN, C. B. McNAIRY AND ROWENA A. McNAIRY, W. H. WEAVER AND EDITH H. WEAVER, *Petitioners*

v.

COMMISSIONER OF INTERNAL REVENUE

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit

PETITIONERS' REPLY TO BRIEF IN OPPOSITION

Pursuant to Rule 24, the petitioners deem it important to reply briefly to respondent's brief in opposition to their petition for a writ of certiorari.

QUESTION PRESENTED

At page 2 of respondent's brief, under the above caption, there appears the issue between the parties. The questions presented by that issue are not stated

tween taxable stock dividends and non-taxable stock dividends for a period of over fifteen years after the decision in *Eisner* v. *Macomber* (1920) 252 U.S. 189, 64 L ed 521, notwithstanding this Court had pointed out such distinctions (298 U.S. at p. 445, 80 L ed at p. 1272, footnote 8). The Commissioner should have at least as much interest as does any taxpayer in clarifying the law which has resulted in conflict between the Circuits.

Point 2

Under this point of respondent's brief (p. 7) he attempts to cover Points 2 and 3 of the petition but fails to answer convincingly either of them. The cases cited by respondent manifest a complete disregard of the congressional intent that, for the purpose of determining the applicability of Section 117(m), the sales or exchanges of stock should be *to outside interests*, also that the "distributions" be limited to distributions *of property*. (H.R. 2319, 81st Cong., 2d Sess. (Pet. App. 32a, 35a); S.R. 2375, 81st Cong., 2d Sess. (Pet. App. 39a, 41a)).

Point 3

Under this point of argument, respondent's brief in opposition (p. 8) purportedly answers the latter portion of petitioners' Point 3 and all of Point 4. It first asserts that the Treasury Regulations 111, Sec. 29.117-11, "are in complete harmony with the broad provisions of Section 117(m), and their legislative history." (p. 8), and, secondly, that "the Committee Reports point out that Section 117(m) was intended to govern distributions which previously were taxable as capital gains under Section 115(d)." (p. 9)

The regulations in question appear in the appendix to respondent's brief at pages 13-27. Under subpara-

graph (a) thereof (p. 13), a distribution under Section 115(d) is not confined to a distribution of property; instead it purports to apply to *all* distributions. The regulations clearly go beyond the plain intendment of Section 117(m) in extending "distributions" under Section 115(d) to include cash distributions.

Lest there be any doubt on that score, Example 1 of the regulations (Resp. App. 23-24) goes so far as to treat as a collapsible corporation transaction the distribution of excess proceeds of an F.H.A.-insured loan, without any reference to a sale or exchange of stock, a liquidation, or a distribution of property. And, that example has been freely accepted as a regulation in harmony with the law in the cases relied upon by the respondent. The Committee Reports specifically confine to a distribution *in property*, the portion of Section 115(d) which is incorporated by reference into Section 117(m), leaving other distributions under 115(d), including cash distributions, unaffected.

"COLLAPSIBLE CORPORATIONS. (a) In General.—With respect to taxable years ending after December 31, 1949, the entire gain from . . . (3) a distribution made by a collapsible corporation which, under section 115(d), is treated, to the extent it exceeds the basis of the stock, in the same manner as a gain from the sale or exchange of property, shall be considered as gain from the sale or exchange of property which is not a capital asset. . . .

"In like manner, the corporation might distribute the *property in question* without liquidating and, under section 115(d), the *excess of the property* distributed, to the extent that it was not a dividend, would first be applied against the adjusted basis of the stock to the shareholders and the *excess*, if any, would be taxable in the same manner as a gain from the sale or exchange of property. Paragraph (1) of the subsection, in prescribing the method to be given the gain from the sale or exchange of stock of a collapsible corporation, is deemed to refer to *this excess value* in the case of a distribution made by the corporation other than in liquidation." (Emphasis supplied.) (Pet. App. 35a, 41a)

Poinf 4

Under this point of argument (Bf. p. 9) the respondent takes issue with petitioners' Point 4 (Pet. Bf. pp. 28-30). He cites S. Rep. No. 1622, 83rd Cong. 2d Sess. p. 260 (3 U.S.C. Cong. & Adm. News (1954 4621, 4898). That report, to the extent that it relates to Sections 312(j) and 341 of the 1954 Code, appears in petitioners' Appendix pp. 45a-49a.

There can be no doubt that Section 312(j) of the 1954 Code had no counterpart in the 1939 Code. Yet, Example 1 of the Commissioner's Regulations under the 1939 Code bears something more than a remote relationship to the subject matter of Section 312(j).

Dealing with Section 341, Collapsible Corporations, the Senate Report states (Pet. App. 49a):

> Subsection (a)(3) incorporates a rule of present regulations that would include gain from a distribution made by a collapsible corporation. . . . This provision would apply, for example, in the case of a corporation engaged in building, and otherwise meeting the tests of a collapsible corporation, which distributes the proceeds of a loan in excess of the adjusted basis of the property by which the loan is secured.[3]

Does not this language of the Senate Finance Committee fully sustain Point 4 of the petition for a writ of certiorari? And, does it not further suggest that Example 1 of the Regulations under the 1939 Code lacked support in the law?

[3] The Senate Finance Committee was not passing upon the validity or invalidity of the regulations,—a judicial function and not a legislative one. It merely stated a fact.

CONCLUSION

It is respectfully submitted that the respondent's opposition to the petition for a writ of certiorari in the instant cases is not well taken.

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